E 2160
Entered

WORLD FINANCE

1935–1937

WORLD FINANCE

1935—1937

By

PAUL EINZIG

LONDON

KEGAN PAUL, TRENCH, TRUBNER & CO., LTD.

BROADWAY HOUSE: 68–74 CARTER LANE, E.C.

1937

Printed in Great Britain by Butler & Tanner Ltd., Frome and London

PREFACE

" THE year 1935 is an important landmark in financial history. It is during that year that the process of world-wide deflation has come to an end and has given way to the irresistible pressure of reflation." This was the opening sentence of my book *World Finance Since 1914*, which I passed for the press in April 1935, and which was published in May of that year. Considering that at that time deflation was still the declared policy of France and a number of other countries whose prices were still on the decline, it was undoubtedly a risky statement to make. Indeed, two months after my statement appeared in print, France witnessed an unprecedented orgy of deflationary measures amounting practically to an all-round cut of 10 per cent by decree. Holland and to a less extent Switzerland were inclined to follow the lead given by M. Laval of ruthless deflation. For a while it appeared as though my forecast that 1935 was to witness the turn in the tide was premature. This was, in fact, pointed out by at least one reviewer of my book.

Nevertheless, I did not for a moment doubt the correctness of my forecast. To my mind it was evident that deflation in France and elsewhere had reached a stage beyond which it could not possibly continue without automatically provoking a reaction in the form of reflation. I was satisfied that, notwithstanding the deflationary cuts in Government expenditure, wages, prices, rents, interest, etc., any decline thus achieved could only be purely temporary and would soon give way to an upward movement.

Developments during 1935–6 have fully confirmed this assumption. Indeed, M. Laval's drastic measures failed to produce even a temporary check on the working of reflationary forces. From June 1935 onwards the index number of prices in France showed an upward movement which has continued incessantly up to the time of writing. In other countries of the former Gold Bloc the turn was not so pronounced as in France, but wherever deflation was in progress during 1935 it gave way to reflation. The experience of that year conclusively proved that it is impossible to carry on deflation indefinitely, even if

the Government is short-sighted and fanatical enough to wish to do so.

The financial history of the years 1935 and 1936 showed the full extent of the disastrous consequences of dogmatic monetary orthodoxy. It provided an example which should serve as a warning against attempting to defend a currency at an overvalued level irrespective of the sacrifices involved. It conclusively proves not only that its costs are far heavier than any nation should ever undertake to bear, but also that in any case the defence is bound to break down in the long run.

The example provided by the experience of France during 1935 and 1936 is indeed unique in financial history. A nation rich, powerful, prosperous and happy, recklessly sacrificed a great part of its wealth, its prosperity, its political power, its internal peace and even its security, for the sake of maintaining its currency at its gold parity. Any novelist who dared to produce such a plot would be accused of suffering from an overdose of imagination. Yet fact is very often stranger than fiction, and the sphere of finance often provides situations worthy of the pen of the greatest of dramatists.

Some of my earlier writings have been criticised on the ground that they over-dramatise situations which have arisen in the sphere of international finance during the last few years. In the light of the experience of the franc in 1935–6 the critics, unless they are utterly devoid of dramatic sense, should revise their opinion. It is impossible not to realise the tragedy that lies underneath the struggle of the franc and other financial developments of recent years. It is hardly possible to overdramatise the facts of recent financial history. They are in themselves dramatic enough.

This book may be subject to criticism on the ground that its criticisms amount largely to "crying over spilt milk". I only wish this were so. Unfortunately, many Governments have utterly failed to grasp the lessons of 1935–6, and keep on "spilling the milk". Indeed, neither they nor Parliaments, the public or the Press appear to have adequately realised the responsibility attached to pursuing a mistaken monetary policy. While mistakes in other spheres have brought retribution upon those guilty of them, Prime Ministers and Central Bank Governors seem simply to thrive on their costly errors of judgment in the sphere of monetary policy. Provided that they repent and recent before it is too late, they are left in charge to repair their mistakes, but more often than not they repeat them instead of repairing them,

having learnt nothing and forgotten nothing. It is high time this easy-going attitude towards the mismanagement of monetary policy was brought to an end. My criticism of the mistakes may possibly err on the side of excessive severity, but the reader ought to remember that those against whom it is directed have been let off much too lightly in the past.

The exceptional gravity of the consequences of M. Laval's mistaken deflationary effort in 1935 is a particularly suitable warning against taking too lenient a view about such mistakes. It is because his successors appear to have learnt so little through his errors that it is necessary to draw attention to them.

P. E.

THE WHITE COTTAGE,
SOUTH BOLTON GARDENS,
S.W.5.
March 1937.

CONTENTS

CHAP. PAGE

PREFACE v

PART I

INTRODUCTORY

I FINANCE AND POLITICS 3

1. Reciprocal Influences.—2. Political Consequences of Monetary Policy.—3. Deflation endangers Peace.—4. The French Example.—5. Finance and National Defence.—6. Need for Drastic Devaluation.—7. Orthodoxy *v.* National Defence.—8. Right Solution for Wrong Reason.

II SCOPE OF THE BOOK 10

1. Recapitulation of Financial History, 1914–35.—2. Failure of Deflation in the Gold Bloc Countries.—3. Crisis of the French Franc.—4. The Dutch and Swiss Crises.—5. Reflation outside the Gold Bloc.—6. Economics of Sanctions.—7. Death-Struggle of the Franc.—8. Devaluation of the Franc and the Tripartite Agreement.—9. Rearmament Finance.—10. Future Prospects.

III WORLD FINANCE, 1914–35 17

1. World History—a History of Inflation.—2. The Fallacy of "Putting the Clock back to 1914".—3. Increase of Indebtedness Ignored.—4. Deflation prevented Normal Adjustment.—5. Internal and International Disequilibrium.—6. Maldistribution of Gold.—7. Slump failed to readjust Disequilibrium.—8. Effect of Currency Depreciation and Devaluation.—9. Limitations of Deflation.

PART II

FAILURE OF DEFLATION

IV THE BELGIAN DEVALUATION AND AFTER . . 27

1. The Weakest Link in the Chain.—2. Effect of Deflation on Belgian Trade and Banking.—3. Flight from the Belga.—4. The Climax.—5. The Political Crisis.—6. M. van Zeeland takes Charge.—7. Devaluation.

V ATTACK ON THE GUILDER 34

1. Repercussions of the Belgian Devaluation upon the Gold Bloc.—2. Why Holland was first to be Affected.—3. The Dutch Devaluationist Movement.—4. Dr.

CHAP. PAGE

Colijn's Resistance to Devaluation.—5. Considerations of Prestige.—6. Flight from the Guilder.—7. End of Selling Pressure.

VI ATTACK ON THE SWISS FRANC 40
1. Consequences of Overvaluation.—2. Banking Difficulties.—3. Flight of Foreign Capital.—4. Flight of Swiss Capital.—5. Speculation.—6. The British Attitude.—7. Defence of the Franc.—8. The Crisis Subsides.

VII THE FIRST FRENCH CRISIS 47
1. France during 1928–31.—2. The Overvalued Franc.—3. M. Flandin's Reflationary Policy.—4. Treasury and Bank of France.—5. Dictatorship of the "200 Families".—6. The Panic of May 1935.—7. The "Man of Destiny".—8. Exit M. Caillaux.

VIII ENTER M. LAVAL 55
1. The Hand of Nemesis.—2. M. Laval and the Crisis of 1931—3. Postponement of the Lausanne Conference.—4. The Abyssinian Game.—5. Short-sighted Policy.

IX DEFLATION WITH MACHINE GUNS 61
1. Hopeless Budgetary Position.—2. Futile Deflation.—3. M. Laval's Decrees.—4. The Consequences of M. Laval's Measures.

X DR. COLIJN'S REMEDY 66
1. Recovery of the Guilder.—2. No Need for Drastic Measures.—3. "Heroic" Effort.—4. Dr. Colijn Yields.

XI THE SWISS BANKING CRISIS 70
1. Withdrawals of Deposits.—2. Excessive Standstill Commitments.—3. Bank Suspensions.—4. Cessation of Withdrawals.—5. Effect of Overvaluation of Currency on Banks.

XII DEVALUATION IN DANZIG 75
1. Overvaluation of the Gulden.—2. Loss of Deposits and Gold.—3. A Mismanaged Devaluation.—4. The Panic of June 1935.—5. The Panic Subsides.—6. Prices and Trade.

XIII THE SECOND FRANC CRISIS 80
1. Prospects of Political Troubles.—2. Inadequate Effects of Deflation.—3. Bank of France becomes more Accommodating.—4. Rise in Prices.—5. The Franc Scare of November 1935.—6. Radicals' Short-sighted Policy.

XIV EXIT M. LAVAL 86
1. Hopeless Outlook for the Franc.—2. Futility and Drawbacks of Prolonged Resistance to Devaluation.—3. A Move towards Devaluation.—4. Electioneering Considerations.—5. Bank of France's Last Efforts to Retain Control.—6. "Après Moi, la Déluge".

PART III

PROGRESS OF REFLATION

CHAP. PAGE

XV DEFLATION REVERSED 95

1. Rising Prices.—2. Public Works Expenditure neutralises Deflation.—3. Political Limits of Deflation.—4. Budgetary and Monetary Limits.—5. Reflationary Effect of Distrust in Stability.

XVI PRESIDENT ROOSEVELT'S REFLATION . . . 100

1. Deliberate Raising of Prices.—2. Results of Reflationary Policy.—3. Reflationary Efforts slowing down in 1935.—4. American Public not Inflation-Minded.—5. President Roosevelt's Achievements.

XVII MR. CHAMBERLAIN'S CONVERSION . . . 106

1. Comparison with President Roosevelt.—2. An Orthodox Start.—3. Cheap Money Policy.—4. Orthodox Advice Rejected.—5. How Far was Cheap Money Deliberate?—6. Active Expansionism in 1935–6.—7. A Gradual but Lasting Conversion.

XVIII DR. SCHACHT REFLATES UNDER PROTEST . . 112

1. Unintentional Reflation in Germany.—2. Public Works and Rearmament.—3. Dr. Schacht's Reluctance to depart from Orthodox Finance.—4. How Public Expenditure was Financed.—5. Dr. Schacht's Position.—6. Is the Vicious Circle likely to Break?—7. Germany's Indebtedness not Excessive.

XIX SIGNOR MUSSOLINI DROPS DEFLATIONARY POLICY . 119

1. The Pesaro Declaration.—2. Why the Lira was Deliberately Overvalued.—3. Signor Mussolini's Monetary Orthodoxy.—4. "Consistent Deflation".—5. Public Works Curtailed.—6. Signor Mussolini's Attitude.—7. Gradual Depreciation of the Lira.

PART IV

SANCTIONIST INTERLUDE

XX FROM PESARO TO ADDIS ABABA 127

1. Italy abandons the Gold Bloc.—2. Letter and Spirit of the Pesaro Promise.—3. The Deadlock in 1935.—4. Effect on Abyssinian Scheme.—5. Raw Material Problem

XXI THE TRAGI-COMEDY OF SANCTIONS . . . 132

1. Irresponsible Statesmanship.—2. Financial Sanctions and Embargo on Exports.—3. Embargo on Imports from Italy.—4. Boycott of Italian Goods not Universal.—5. Italy's Forced Exports and Reduced Imports.—6. Italy's Gold Resources.—7. Sanctions "Leaking like a Sieve".—8. "Sanctionist" Yugoslavia.

CHAP. PAGE

XXII THE ECONOMIC CONSEQUENCES OF SANCTIONS . 139

1. Sanctionist Statesmen's Optimism.—2. Prophecies of "Collapse".—3. Rising Prices and the Lira.—4. A Blessing in Disguise.—5. British Trade's Losses.

PART V

THE BATTLE OF THE FRANC

XXIII BOLSTERING UP THE FRANC 147

1. General Public Exports Capital.—2. Resources Available for Exporting Capital.—3. Hoarding of Foreign Notes and Gold Coins.—4. Bank of France demands Further Deflation.—5. The London Credit and its Gold Security.—6. Those "200 Families".

XXIV FINANCIAL BACKGROUND OF THE RHINELAND OCCUPATION 154

1. Political Effect of Repudiation of Locarno.—2. Need for Display of Strong Hand.—3. Lack of Firmness due to Financial Reason.—4. Security Sacrificed in Order to Maintain Franc.—5. "Something More Important".—6. Cui Bono?

XXV VERDICT OF THE FRENCH ELECTORATE . . 159

1. Deflation Condemned. — 2. Responsibility for Deflation.—3. Fresh Flight from the Franc.—4. Anticipation of Socialist Victory.—5. Electorate rejects Deflation.—6. The Political Consequences of M. Laval's Deflation.

XXVI AFTER THE FRENCH ELECTION 166

1. "Interregnum".—2. Credit Expansion in Spite of High Bank Rate.—3. Reassuring Statements.—4. French "Invasion" of London.—5. Unofficial Embargoes.—6. Treasury's Difficulties.

XXVII ORTHODOX DEVALUATIONISTS 172

1. Sudden Changes of Opinion.—2. Enter Professor Rist.—3. Conversion of an Arch-Deflationist.—4. M. Germain Martin and Devaluation.—5. Lesser Diehards Capitulate.—6. Making M. Blum's Task more Difficult.

XXVIII SQUARING THE CIRCLE 178

1. Radical Anti-Devaluationists. — 2. Monetary Orthodoxy of Communists.—3. Social Legislation.—4. Stay-in Strikes.—5. Trade Deadlock.—6. Reflation without Devaluation.—7. Preparing the Way for Devaluation.

XXIX PROLONGING THE AGONY 185

1. An Unenviable Task.—2. Exit M. Tannery.—3. End of an Anachronism.—4. Flight of Capital comes to a Halt.—5. A Short-lived Respite.—6. Prolonging the Agony.

CHAP. PAGE

XXX THE DEVALUATION OF THE FRANC . . . 191
1. The Last Weeks of the Poincaré Franc.—2. Solutions Suggested.—3. Beginning of the End.—4. More Hesitation.—5. Devaluation at Last!

PART VI

THE TRIPARTITE AGREEMENT

XXXI THE CONTROVERSY AROUND STABILISATION . . 199
1. "Stabilisation Offensives".—2. Bank of England's Attitude.—3. London School of Economics and Sound Currency Association.—4. Bankers, City Editors and Politicians.—5. Opponents of Stabilisation.—6. The Stabilisationist Movement in the United States.—7. International Institutes favour Stabilisation.

XXXII THE FRENCH ATTITUDE TOWARDS STABILISATION . 205
1. Deflation for its Own Sake.—2. Misguided Puritanism.—3. Attitude of French Stabilisationists.—4. An Ingenious Formula.—5. "Alignment" *v.* Devaluation.—6. M. Blum's Negotiations.—7. The Rate of Devaluation.

XXXIII THE AMERICAN ATTITUDE TOWARDS STABILISATION 211
1. Deliberate Depreciation of the Dollar.—2. Mr. Morgenthau's Move.—3. Desire to Undervalue Dollar.—4. To prevent Undervaluation of Sterling.

XXXIV THE BRITISH ATTITUDE TOWARDS STABILISATION . 216
1. Turn in the Trend of Sterling in 1935.—2. Public Opinion against Stabilisation.—3. Why Mr. Chamberlain rejected Stabilisation.—4. Disequilibrium within the Sterling–Dollar–Franc Triangle.—5. The Abyssinian War.—6. Mr. Chamberlain's Dilemma.

XXXV THE TRIPARTITE AGREEMENT 222
1. The Statement of September 26, 1936.—2. An Orthodox Victory.—3. Gold Earmarking Arrangements.—4. Informal and Provisional Stabilisation.—5. Disadvantages of Tripartite Agreement.—6. Tripartite Agreement blocks Process of Adjustment.

PART VII

AFTER THE DEVALUATION OF THE FRANC

XXXVI THE FRANC AFTER DEVALUATION . . . 231
1. "Vindictive" Measures.—2. Political, Moral and Practical Considerations.—3. Inadequate Degree of Devaluation.—4. Budget and Treasury not Sufficiently Relieved.—5. Possibility of Further Devaluation.

XXXVII THE TWILIGHT OF THE GOLD BLOC . . . 237
1. Holland and Switzerland.—2. Material *v.* Psychological Factors.—3. An Impossible Task.—4. The Last Denial.—5. The Rate of Devaluation—6. End of the Gold Bloc.

CHAP. PAGE

XXXVIII THE DEVALUATION OF THE LIRA 243
1. Effect of French Devaluation.—2. The Fascist Attitude.—3. Signor Mussolini's Belated Decision.—4. Better Late than Never.—5. Italy's Excessive Public Debt.—6. Degree of Devaluation.

XXXIX MORE DEVALUATIONS 248
1. Anticipated Monetary Changes.—2. German Political Pressure against Devaluation.—3. Attitude of Little Entente Countries.—4. The Polish Formula.

XL GERMAN DEVALUATION DEFERRED . . . 252
1. Berlin sulking over Tripartite Agreement.—2. Dr. Schacht's Conditions.—3. Debtors' Dictatorship.—4. Germany would stand to Gain through Devaluation.—5. The British Point of View.—6. The International Point of View.

XLI HOLLAND AND SWITZERLAND AFTER DEVALUATION . 257
1. Swiss Franc Undervalued.—2. Trade Revival and Repatriation of Capital.—3. Influx of Foreign Funds Resumed.—4. The Guilder at Equilibrium.—5. Blundering with Impunity.

XLII THE NEW GOLD STANDARD 262
1. Changing Definition of Gold Standard.—2. No Rigid or Permanent Stability.—3. Theory and Practice.—4. Significance of the Gold Earmarking Agreement.—5. Increased Rigidity of Exchanges.—6. Elimination of Private Arbitrage.

XLIII M. AURIOL'S CONCESSION TO CAPITALISTS . . 268
1. Repatriation and Dishoarding.—2. Technical Position of the Franc Improved.—3. Export of French Capital Resumed.—4. French Banks' "Passive Resistance".—5. Missed Opportunities.—6. Inflationary Borrowing Resumed.—7. A London Credit.

XLIV STERLING AND THE DOLLAR UNDER THE TRIPARTITE AGREEMENT 274
1. Relapse of Sterling after Devaluation of the Franc.—2. Selling of Sterling on Account of Soviet Government.—3. The Flow of Funds to Wall Street.—4. Recovery of Sterling.—5. Reduction of the Fiduciary Issue.

PART VIII

REARMAMENT FINANCE

XLV "WEHRWIRTSCHAFT" 281
1. Germany and Rearmament.—2. Military *v.* Civilian Requirements.—3. Public Debt not Excessive.—4. Raw Material Supplies.—5. Dr. Schacht's Foreign Trade Formula.—6. The "Food Shortage" Bluff.

CHAP. PAGE

XLVI BRITISH REARMAMENT FINANCE 288

1. Financial and Industrial Aspects.—2. Should Rearmament be Financed by Taxation?—3. Financing of Rearmament through Borrowing.—4. No Self-inflicted Penalty.—5. Increase in Burden of Debt necessitates Depreciation of Sterling.—6. Industrial Limitations of Rearmament.—7. Need for accumulating Food and Raw Material Supplies.

XLVII FRANCE'S SELF-IMPOSED HANDICAP 295

1. Difficulties of Borrowing before Devaluation.—2. Inadequate Result of Devaluation.—3. Rediscounting Treasury Bills.—4. Disguised Inflationary Borrowing.—5. The Hoarding Habit.—6. A Conciliatory Gesture.

XLVIII REARMAMENT AND REFLATION 301

1. Rearmament Finance in Western Europe.—2. Rearmament Problems of Poor Countries.—3. Recovery of Raw Material Producing Countries.—4. World-wide Recovery.—5. How the Bill will be Paid.

PART IX

FUTURE PROSPECTS

XLIX STABILISATION DREAMS 309

1. Tripartite Agreement stimulates Stabilisation Movement.—2. Disequilibrium beneath Surface Stability.—3. Perpetuating Disequilibrium.—4. The Franc and Sterling.—5. Dollar's Strength.—6. Political Uncertainty.—7. Popular Demand for Expansion.—8. Is there too much Gold?

L THE OVERVALUED POUND 315

1. Sterling–Dollar Rate around 4.90.—2. Policy on a 24-hour Basis.—3. Is Sterling Overvalued?—4. Measurement of Overvaluation.—5. Britain's Trade Deficit.—6. Invisible Exports.—7. Forward Dollars indicate Overvaluation of Sterling.

LI THE BRITISH POLICY 321

1. Expansion and Rearmament.—2. Orthodox Economists raise False Alarm.—3. The Gold Position.—4. Choice between Tripartite Agreement and Cheap Money.—5. The Long View.

LII THE AMERICAN POLICY 326

1. President Roosevelt drifting towards Orthodoxy.—2. Causes of Change of Policy.—3. The Labour Factor.—4. British Prices likely to rise Faster than American Prices.—5. Need for allowing Sterling to Depreciate.

CHAP. PAGE

LIII CONCLUSION 331

1. Defence of Currency at All Costs.—2. Trade Revival at All Costs.—3. Rearmament at all Costs.—4. Reflation and Disequilibrium.—5. Effect on Internal Disequilibrium.—6. Effect on International Disequilibrium.

INDEX 337

PART I
INTRODUCTORY

CHAPTER I

FINANCE AND POLITICS

(1) Reciprocal Influences

It is generally known that finance and politics are closely interrelated. Even before Baron Louis, the French Finance Minister of the Restoration, addressed his much-quoted remark to his colleagues in the Cabinet: "*Faites-moi une bonne politique et je vous ferai de bonnes finances,*" the dependence of financial conditions upon the satisfactory state of politics had been widely realised. In innumerable recent instances there was, in fact, no need to draw attention to it, for it was self-evident. It was the major political event of the war of 1914–18 that brought about the fundamental change in the world's financial situation for which we are still unable to find a solution. War and civil war inevitably produce profound effects in the sphere of finance. Internal political developments become at times the predominant factor in finance. Indeed, as I pointed out in my book *Monetary Reform in Theory and Practice,* political considerations are apt to become the leading factor in shaping a country's monetary policy. It is also widely known that statesmen and diplomats often make use of financial means to achieve political ends. In my books *Behind the Scenes of International Finance* and *Finance and Politics,* I quoted some characteristic examples of political finance, its cause and consequences.

What is less generally known is the degree to which relations between finance and politics are reciprocal. On the one hand politics become at times the predominating influence in the sphere of finance; on the other hand, financial factors occasionally become the major influences in the sphere of politics, internal or international. The extent to which a mistaken financial policy can, in given circumstances, influence the course of political events is not sufficiently realised. One of the main objects of this book is to draw attention to it.

(2) Political Consequences of Monetary Policy

During the period covered by my book *World Finance Since 1914,* the influence of finance on politics was not glaringly

evident. It was during the period covered by the present book that the financial factor among the major influences in politics assumed predominance. Even before 1935 the financial factor was from time to time unmistakably present among the influences that shaped the course of history. British disarmament since the war, which was to play such a fateful, if passive, rôle in recent history, was to a large degree the result of the restoration of the pound to its pre-war parity, which necessitated ruthless cutting down of budgetary expenditure. It was largely, though by no means exclusively, this financial factor which was responsible for the weakening of the British Empire to a point at which it was no longer able to fulfil its pacifying function in world politics. It was the mistaken deflationary policy pursued under the Government of Dr. Brüning during the depression, and more especially after the crisis of 1931, that was largely responsible for the advent of Herr Hitler, with all its incalculable consequences on world history. It was the financial crisis of 1931 that diverted the attention of Europe and the United States from Japan's expansionary policy in Manchukuo. The examples could be multiplied; they could easily be found also during earlier periods of history, since there is very little new under the sun. But seldom, if ever, has the predominance of the financial factor become so strikingly evident as during 1935 and 1936.

In 1935 the mistaken monetary policy pursued by Signor Mussolini led to the Abyssinian adventure, which might easily have resulted in another European war and which, as it is, has completely changed the political constellation in Europe. From an Italian point of view the adventure into which Signor Mussolini was forced by the deadlock brought about by his monetary policy has turned out to be profitable so far. The risk involved was, however, disproportionate to the result. Moreover, Italy had to pay a big price for the conquest of Abyssinia: she had to relinquish her hegemony in Central Europe in favour of Germany, and she had to sacrifice the security of her northern frontiers. The Italian experience provides an interesting example of how an ill-advised monetary policy is capable of driving a nation to finding *divertissement* in the form of war.

(3) Deflation endangers Peace

When writing *World Finance Since 1914*, I thought I had made out a very strong case against deflation by giving an account of its disastrous consequences in the economic and

financial sphere. That picture, however, fades into the background in face of the facts presented in the present volume. The sufferings inflicted upon mankind by the growth of unemployment, contraction of purchasing power, failure of banks and industrial and commercial enterprise, disappear into insignificance compared with war, or even the terror spelt by the mere threat of war. After all, amidst modern conditions of social services and charitable activities, even the unprecedented unemployment of 1931 and subsequent years did not lead to actual starvation. In spite of the misery of the masses, there was life and there was hope. Although life offered very little indeed to millions, it was nevertheless better than living in prosperity but under the cloud of imminent destruction through war.

When the depression was at its worst and there appeared to be no ray of hope for recovery, many people were inclined to believe that even a war could not be worse than the state of affairs then existing. It was easy for them to say so, since the possibility of another war appeared very remote. In the meantime, largely as a result of mistaken monetary policy, the menace of war has become something terrifyingly real. Many of us would wish the world were back in the darkest days of the depression of 1931–2, if only the political clock could also be put back. The horrors of the Italo-Abyssinian war and those of the Spanish civil war provided in the meantime some slight foretaste of things to come.

(4) The French Example

The extent of the influence of monetary policy upon the course of political developments was glaringly evident in the example provided by developments in France and by the way in which Germany took advantage of those developments. Indeed, while the Abyssinian war was but an interlude, the political consequences of the stubborn defence of the franc at an overvalued level resulted in a complete change in the balance of power, and altered the course of world history, possibly for generations. It was because the energies of France were focussed upon the defence of the franc that Hitler took his chance and reoccupied the Rhineland in March 1936. It was because of the reaction of the French electorate to the deflationary monetary policy pursued by M. Laval that the general election in April–May 1936 brought in a Socialist Government which was severely handicapped by the lack of discipline of its own supporters at a time when a strong Govern-

ment was especially essential from an international point of view. The stay-in strikes, that were but one of the many symptoms of lack of discipline and demoralisation in France, were the logical consequence of M. Laval's deflation with the aid of machine guns. The mistaken French monetary policy secured the supremacy of National Socialists in Germany over Europe. We have seen that, because France was too much preoccupied with her financial problems, Hitler dared to re-occupy the Rhineland. It was because the French Government was afraid that energetic action, following upon this breach of the Treaty of Locarno, would lead to the collapse of the franc, that he was left in undisturbed possession of the remilitarised and refortified province. Indeed, the prolonged defence of the franc brought France to the verge of revolution. Although the devaluation of September 1936 averted that disaster, it came too late to prevent a decline of the financial and political power of France. Her statesmen sacrificed the security of the country for the sake of monetary orthodoxy.

In 1934 I ended my book *France's Crisis* with the remark that the French nation had to choose between the franc and France. Unfortunately it chose the franc, with the result that it sacrificed the supremacy and security of France, without being able to save the franc even at the cost of that enormous sacrifice.

(5) Finance and National Defence

In face of the all-important problem of peace, the problems of restoring financial and economic equilibrium discussed in *World Finance Since 1914* would fade into insignificance but for the fact that they continue to have a bearing on the political situation and outlook. At the time of writing politics appear to have gained the upper hand. Finance has become once more the passive factor used and abused for political purposes. Considerations of budget and monetary policy have ceased, for the time being, to dominate the course of political events. They have to follow the supreme requirements of national defence. The pace at which budgets will be unbalanced and currencies will be allowed to depreciate will be dictated by these requirements, and not by any financial considerations, orthodox or otherwise.

Until recently, the main point of discussion was whether or not and to what extent it is justifiable for a State to spend its way to prosperity. To-day the volume of public expenditure through rearmament is no longer affected by any desire

to create employment, or by any fear of unbalancing budgets and increasing public debt. It is dictated solely by the real or imaginary danger of an imminent war, for fear of which the nations strain their financial resources to the utmost in order to be forearmed. The political factor has gained predominance in the sphere of finance almost to the same extent as it did during the war.

(6) Need for Drastic Devaluation

In the circumstances, the question of outstanding importance is how the various nations will be able to stand this armament race from a financial point of view. In *World Finance Since 1914* I developed the thesis that the increase of fictitious wealth in the form of public and private indebtedness, inherited from the war and its consequences, was the main cause of the fundamental disequilibrium which led to the depression of 1929–35 and which constituted the main obstacle to fundamental and lasting recovery.. I argued that the main object of monetary policy should be to find a way by which this excessive fictitious wealth could be reduced in relation to the volume of existing real wealth. My conclusion was that drastic devaluation of all currencies was the only way in which this end could be achieved. In the meantime the excessive burden of public debt in France led to the devaluation of the franc, followed by the devaluation of the lira and other currencies.

This devaluation constituted an important step towards the scaling down of the excessive fictitious debt, but in my opinion it has not gone nearly far enough to achieve the desired end, especially as rearmament expenditure is likely to increase the volume of fictitious debt quite considerably during the next few years. Additional devaluations will be necessary to an even larger degree than I anticipated before the beginning of rearmament expenditure on a really large scale. The circumstances in which the franc was devalued show that the necessity for this is not yet adequately realised. In order to avoid a further depreciation of sterling and the dollar, the French Government limited the extent of the devaluation of the franc to the barest minimum sufficient to restore equilibrium between French prices and the world level but without allowing a safety margin for the rise in French prices that could reasonably be expected to take place through devaluation, social legislation and internal inflation.

(7) Orthodoxy *v.* National Defence

But for the presence of the political factor, the Governments would probably attempt to patch up the situation by stabilising the currencies at a level which would not solve the major problem of excessive fictitious wealth. Although they have learnt that in face of major disequilibrium it is futile to attempt to maintain existing gold parities, they are still orthodox enough to want to keep the depreciation of their currencies to the minimum compatible with technical conditions. It is because of the requirements of national defence that this orthodox attitude will have to be abandoned. In face of the pressure for larger and larger expenditure, sterling, the franc and other European currencies will prove to be untenable at their present gold value.

A few years ago, when the international political horizon was reasonably clear, this would have meant the suspension of the armament race. In the existing conditions of political tension, however, it will mean the suspension or abandonment of monetary orthodoxy. The fact that large and increasing budgetary deficit due to rearmament makes it impossible for the British or French authorities to maintain sterling or the franc at their present level in relation to the dollar or to gold does not mean that they will enforce economy in the expenditure on national defence. It means that the monetary authorities will reluctantly be compelled to yield to the higher considerations of national defence and allow their currencies to find a level at which even the increased expenditure and the increased public debt is not unbearable. Excessive fictitious wealth will thus be liquidated through the sheer necessity to rearm.

(8) Right Solution for Wrong Reason

It is unfortunate that often the right solution can only be stumbled upon for the wrong reason. Had the orthodox conception been abandoned not in consequence of the pressure from the political factor but before that pressure arose, the world would still be enjoying the prospects of prolonged peace. The strength of France would not have been frittered away; the Stresa front, which was the only possible safeguard for peace, would still exist and, in face of it, German expansionary ambitions would be unable to endanger the peace of Europe.

The examination of the way in which this generation's chances of avoiding another world war, even more destructive

than the last one, have been sacrificed upon the altar of monetary orthodoxy is the main object of this book. The financial history of the last two years is indeed of outstanding interest to the student of politics, and certainly deserves more attention than it has received so far outside circles interested in financial matters. It is important that the general public should also grasp the political significance of monetary policy. In denouncing mistakes of the past, my object is to draw attention to the possibility of adopting a rational attitude in the future. Should the world by some miracle escape this time the *full* political consequences of monetary orthodoxy, it would be tempting Providence if a similar situation were to be allowed to arise in the future owing to a lack of adequate realisation of the lessons of the past. Public opinion should realise that, apart altogether from economic considerations, the political consequences of stubborn deflationary defence of currencies are apt to be fatal, and should be avoided at all costs.

CHAPTER II

SCOPE OF THE BOOK

(1) Recapitulation of Financial History, 1914–35

The period covered by this volume began with the devaluation of the belga, which constitutes one of the most important landmarks in the history of financial developments since 1914. It ranks in importance with the unpegging of the allied exchanges in 1919, the return to the gold standard in Great Britain in 1925, the stabilisation of the franc in 1928, the suspension of the gold standard in Great Britain in 1931, and the suspension of the gold standard in the United States in 1933. It was the starting-point of the death-struggle of the Gold Bloc. If there was until March 1935 a remote chance for the Gold Bloc to resist devaluation in the long run—a view which I never accepted—it effectively vanished when the weakest link in the chain of gold currencies broke.

The events that led to the devaluation of the belga were described in *World Finance Since 1914*. The contents of that volume are summarised in Chapter III for the use of readers who have not read it. The periods of war and post-war inflation, post-war stabilisation, post-1929 deflation and reflation, are described in a nutshell, together with the evolution of conceptions in monetary policy.

(2) Failure of Deflation in the Gold Bloc Countries

Chapters IV–XIV give an account of the definite failure of deflationary efforts in the countries of the Gold Bloc. After examining the significance of the Belgian devaluation upon the international financial position, the book describes the attacks on the Dutch guilder and the Swiss franc, which took place immediately after the devaluation of the belga. It is a widespread conception that Holland and Switzerland might have avoided devaluation but for the inherent weakness of the French franc and the psychological effect of the latter's devaluation in 1936. In my opinion, apart altogether from developments in France, the devaluation of the guilder and Swiss franc was also a mere question of time. These cur-

rencies might conceivably have held out longer, but could not have avoided their fate. On the basis of this conception, I regard the attacks on the two minor Gold Bloc currencies in April and May 1935 as having been rather more than reckless speculation encouraged by profits made on the devaluation of the belga. They were manifestations of an underlying trend which sooner or later was bound to become irresistible in spite of the initial success of the Dutch and Swiss authorities in resisting the attacks.

(3) Crisis of the French Franc

The crisis of the French franc, which followed the attack on the guilder and Swiss franc, is described in some detail, with special regard to the rôle played by orthodox *haute finance* controlling the Bank of France, in the political crisis that led to the downfall of two French Governments in close succession. After MM. Flandin and Bouisson had been unable to obtain Parliament's approval to carry out the deflationary measures imposed upon them by the Bank of France, the subtle M. Laval succeeded where his predecessors had failed. His political success proved in the long run fatal for France. He had already given evidence of his lack of statesmanlike foresight in 1931 and 1932, when his resistance to a reasonable solution to the problem of reparations, and especially his insistence upon the postponement of the Lausanne Conference from January to June 1932, led to the downfall of the moderate Government of Dr. Brüning and was thus responsible for the subsequent advent of Hitler.

In 1935 M. Laval crowned his work of statesmanship by embarking upon a reckless course of " consistent " deflation by decree, as described in Chapter IX. In doing so, he was taking a leaf out of Signor Mussolini's book without realising that what might be possible for a short while under a dictatorship could not be done in a democratic state. It was his fanatical deflationism which paved the way for the Socialist-Communist victory at the General Election in April 1936, and was responsible for the internal weakness of France at a time when a display of strength was vital.

(4) The Dutch and Swiss Crises

If M. Laval's ruthless attempts at deflation contained all the elements of major tragedy, their emulation by the Dutch Premier, Dr. Colijn, has all the elements of the classical comedy. Chapter X describes how this stubborn Dutchman, desirous

of displaying financial heroics entirely unnecessary in Dutch conditions, brought a series of minor crises upon his country; how after his display of heroics he came to the conclusion that discretion was the better part of valour and abandoned the programme that he had formerly declared to be vital for saving the guilder.

In the following chapter the fundamental troubles of Switzerland are discussed. As in the United States and Belgium, so in Switzerland, the main cause of the inherent weakness of the currency was the weakness of the banking situation. Sooner or later that factor would have produced the same result as in the United States and Belgium. It was only at the cost of allowing the banking position to deteriorate further that the defence of the Swiss franc could be continued.

Then follows a description of the failure of M. Laval's drastic economy decrees to bring any lasting relief to the franc, and the series of political crises which eventually led to the well-deserved failure of his Government.

(5) Reflation Outside the Gold Bloc

Part III of the book, containing Chapters XV–XIX, opens with a survey of how in France and other deflationary countries the forces of reflation were gaining ground while the Governments nominally pursued a deflationary policy. It then describes the progress of reflation in countries which have openly abandoned the fight against it and have even adopted the policy of encouraging it. Chapter XVI describes the progress of reflation in the United States, leading to a marked improvement of trade conditions in spite of the reverses suffered by the administration through the Supreme Court's anti-New Deal decisions. The following chapter deals with the development of reflation in Great Britain, largely as a result of Mr. Chamberlain's conversion from budgetary orthodoxy to a policy of spending. Unfortunately, under the influence of political developments this spending had to assume largely the form of expenditure on rearmament.

Chapter XVIII gives an account of the progress of reflation in Germany, where it reduced unemployment to practically normal proportions. It describes the paradoxical state of affairs in which a man who put a reflationary policy into operation with admirable efficiency—Dr. Schacht—did so under protest and contrary to his firm conviction that this policy was bound to lead to disaster. Germany's reflationary experience is well worth examining in detail, as it provides a remark-

able example of the fact that a lack of adequate financial resources in the form of accumulated savings is not necessarily an obstacle to spending on a gigantic scale. While the majority of reflationary spending in Germany served the destructive purpose of rearmament with aggressive intention, a by no means inconsiderable proportion was spent for essentially constructive purposes.

(6) Economics of Sanctions

In the senior totalitarian state, Italy, the same policy was carried out, though, in the absence of a Dr. Schacht, with less efficiency. Having dropped his deflationary policy in 1934, Signor Mussolini embarked upon reflationary expenditure on rearmament in connection with the Abyssinian campaign and the general international political tension. The lira was allowed to depreciate gradually in the unofficial market, and a "tourist lira" was introduced on the model of registered marks. These developments certainly broke the deflationary deadlock from which the country had suffered until the end of 1934.

Part IV of the book deals with the disturbing factors provided by the adoption of economic sanctions against Italy. In Chapter XX I have tried to examine the extent to which Signor Mussolini's reluctance to devalue the lira was responsible for his decision to embark upon the Abyssinian campaign. In Chapters XXI and XXII the ill-advised efforts of the League of Nations to check the Abyssinian campaign by means of futile economic and financial sanctions are criticised.

(7) Death-Struggle of the Franc

After this interlude we return in Part V to the main subject of the book, which is the death-struggle of the Gold Bloc. Chapter XXIII describes the situation under the Sarraut Government, which had not the courage either to devalue or to make any efforts for the defence of the franc. It gives an account of what happened behind the scenes concerning the British credit of £40,000,000 to the French Treasury, one of the outstanding examples of the supreme art of make-believe. This comedy of the franc developed into tragedy when, in March 1936, Hitler took advantage of the French preoccupation with the defence of the franc to reoccupy the Rhineland. Chapter XXIV describes how it was the desire of defending the franc that prevented France from taking energetic action

which at that stage would have been sufficient to induce Germany to respect treaties.

In Chapter XXV the victory of the parties of the Left at the General Election is presented as the natural, logical and inevitable consequence of M. Laval's policy of deflation and M. Sarraut's policy of inaction. The effect of the anticipated change of monetary policy under the Socialist Government is dealt with in Chapter XXVI. The disadvantages of a system in which a Government has to survive its defeat by nearly two months without being able to do more than carry on routine business are clearly indicated by the crisis of the franc of May 1936. In Chapter XXVII the attitude of conservative economists and politicians who turned overnight from fanatical anti-devaluationists into equally fanatical devaluationists is criticised.

Chapters XXVIII and XXIX deal with the deplorable efforts of MM. Blum and Auriol to pursue an orthodox monetary policy notwithstanding their utterly unorthodox economic and social policy. The futile attempt to maintain the franc at its old parity in spite of the rapidly rising cost of production, and the rôle played by Communist influence in shaping this policy, are described.

Chapter XXX describes the circumstances in which M. Blum eventually decided to abandon the struggle to maintain the franc. It describes the details of the long overdue devaluation, and appraises the general significance of the change it brought about.

(8) Devaluation of the Franc and the Tripartite Agreement

In Part VI we examine the circumstances that led to the conclusion of the Tripartite Agreement simultaneously with the devaluation of the franc. The French, American and British attitudes since 1931 towards stabilisation, and their reconciliation in the Tripartite Agreement, are discussed in some detail.

Part VII of the book deals with the effects of the devaluation. In Chapter XXXVI the ill-advised French efforts to keep devaluation to the bare minimum with the aid of the Tripartite Agreement is criticised. The real significance of that agreement and the gold-earmarking agreement that followed it is examined. The following three chapters deal with the decision of Signor Mussolini to devalue, and with the attitude of the remaining countries towards devaluation. Chapter XL ex-

amines the causes and consequences of Germany's refusal to swim with the tide. Subsequently the effects of devaluation upon conditions in France and other Gold Bloc countries, and the indirect effect on the world in general, are described.

(9) Rearmament Finance

In Part VIII the financial situation in the principal European countries is examined from the point of view of rearmament finance. We return once more to the examination of the highly efficient system elaborated in Germany for the financing of gigantic rearmament expenditure. Chapter XLVI gives an account of the financial problems raised in Great Britain by the requirements of rearmament, with special regard to the already excessive amount of public debt. The following chapter deals with rearmament in France, which is no longer handicapped to the same degree as before by the policy of defending the franc.

Chapter XLVIII raises the question whether the growing requirements of the armament race will not lead to wholesale inflation, second only to that experienced during the last war. In some instances, at any rate, expenditure has already exceeded the proportions which may be considered as reflation, and is now definitely of an inflationary character.

(10) Future Prospects

Prospects of stabilisation in the light of these developments are examined in Part IX. It denounces the lack of sense of reality on the part of those who, notwithstanding political uncertainty and inflation through rearmament, advocate immediate monetary stabilisation. It brings into relief the incompatibility of the requirements of national defence with a reversion to monetary orthodoxy. Doubts whether the devaluation of the franc is final, and the fact of the overvaluation of sterling compared with the dollar, are additional reasons why stabilisation is not expected to be a matter of practical politics for a long time. The difficulties caused by the overvaluation of the pound are examined in Chapters L and LI.

Short-sighted American policy in insisting upon a sterling-dollar rate which would secure a constant westward flow of gold is denounced in Chapter LII. Reasons are given why the overvaluation of sterling in relation to the dollar is expected to become further accentuated in the course of the next few years. The fact that it is the declared policy of the

United States to depreciate the dollar if sterling should depreciate further foreshadows the possibility of a depreciation race, as a result of the rearmament race, which might force the British authorities to allow sterling to depreciate. The general conclusions are summarised in the following chapter, which lays stress on the effect of rearmament on internal and international equilibrium.

CHAPTER III

WORLD FINANCE, 1914–35

(1) World History—a History of Inflation

It is a difficult task to summarise in a brief chapter the immense material of facts covering the period since 1914. I propose to confine myself to giving the outlines of fundamental tendencies from the beginning of the war until the devaluation of the belga.

The history of the world is the history of inflation. Throughout the ages the value of the monetary units tended to depreciate in the long run, even though the process was from time to time interrupted and occasionally temporarily reversed. At times the historical trend of depreciation assumed the form of depreciation in relation to the metals that formed the basis of the currencies. In other periods the stability of the monetary unit in relation to its metallic basis was maintained but the value of both monetary unit and its metallic equivalent in terms of commodities depreciated. The British system of units of account—pounds, shillings and pence—is in itself the symbol of this progress of inflation throughout the ages. As mediæval accounts bear witness, the penny was an important unit in the pre-Tudor days. Its place was taken by the shilling, in terms of which wages were expressed in the early Tudor days. Following upon the world-wide depreciation of the monetary unit after the discovery of America, the pound came to play the same part which had been played by the shilling and earlier by the penny.

From time to time during an exceptionally stable period or under an exceptionally strong régime, the process of depreciation in various countries was checked, but in face of the requirements of wars it was impossible to resist the temptation to debase the unit for any length of time. It was only during intervals between major wars that the inexorable process of inflation could at times come to a halt. The period between the Napoleonic wars and the World War of 1914 provided such a respite in Great Britain and Western Europe in general, though the historical process continued in great parts of Central,

Eastern and Southern Europe, not to speak of Latin-America and the United States.

(2) The Fallacy of "Putting the Clock back to 1914"

It was because in the Western European countries the process of inflation came to a halt before 1914 for a relatively long period that the conception gained ground that in modern conditions the monetary unit was necessarily stable. This conception had taken root to such an extent that it blurred the world's vision about the real significance and consequences of the reckless inflation brought about by the world war. It was believed in all seriousness, not only by the public, who could hardly be blamed for knowing no better, but also by those who were regarded as experts, that once peace was concluded the clock would be put back to 1914 and prices would decline to their pre-war level. It was this conception which delayed the effect of inflation during the early period of the war. The existence of inflation was not adequately realised, and its consequences were not anticipated.

It was not until after the war that the world realised that the conclusion of peace did not mean a return to pre-war conditions. The pendulum of inflation, which was held back until 1919 by the blissful ignorance of the public and its advisers, swung then to the extreme. Exaggerated anticipation of the destructive effect of inflation resulted in conditions in which Governments had no alternative but to live up to these anticipations. During 1919 and 1920, war inflation produced its belated effects. This was to a large degree a natural movement. As on the occasion of previous wars, the monetary unit tended to find a level at which the burden of war expenditure became less unbearable. Had the tendency been allowed to take its course, and had the monetary units been stabilised at the low point to which they depreciated in terms of commodities in 1920, much of the trouble experienced in subsequent years could have been avoided.

(3) Increase of Indebtedness Ignored

This poor ignorant world of ours could not, however, stumble upon this obvious solution. The belief in the stability of currencies at their pre-war parities was so strong that it obscured the glaring facts calling for a different formula. Statesmen, economists and the public did not give adequate thought to the consequences of the increase of fictitious wealth through war inflation. They failed to realise the state of

disequilibrium between the post-war volume of such fictitious wealth and the volume of real wealth, which actually declined through the destruction of the war. They failed to realise that the possession of fictitious wealth, whether in the form of banknotes, bank deposits, Government loans, or private loans of every kind, gave the holder a claim on existing real wealth and current production, and that, in consequence, if the volume of this fictitious wealth increased without a corresponding increase of the volume of real wealth which it could purchase, a state of chronic disequilibrium arose. It called for a corresponding downward adjustment of the monetary unit in which fictitious wealth is expressed. Otherwise holders of fictitious wealth would have a disproportionate claim upon existing real wealth and current production to the detriment of the productive classes which would have to bear the burden of this excess.

Doubtless the situation could have corrected itself also by an increase in the production of real wealth. Such an increase could, however, have taken place only through a monetary policy enabling producers to use the full extent of their technical capacity and enabling consumers to purchase the increased volume of products.

(4) Deflation prevented Normal Adjustment

In adopting a policy aiming at the restoration of the monetary unit to its pre-war value, Governments of the post-war period effectively prevented the readjustment of the disequilibrium between fictitious and real wealth either through a depreciation of the monetary unit or through an expansion of production and consumption. The policy of deflation from 1920 onwards in the United States, Great Britain and a number of other countries ruled out the possibility of any such fundamental adjustment.

It is true that in a number of countries the Government had to abandon the idea of restoring the pre-war value of the currency. They went, however, to the other extreme by allowing inflation to take place in circumstances which led to a considerable increase of the burden of fictitious indebtedness, in spite of the depreciation of the monetary unit. Even in Germany and a few other countries, where fictitious wealth was wiped out almost completely by the utter depreciation of the monetary unit, the reconstruction of savings took place in circumstances which led to an accumulation of excessive indebtedness. Thus, neither post-war deflation nor post-war

inflation succeeded in solving the problem of fundamental disequilibrium caused by excessive fictitious wealth.

(5) Internal and International Disequilibrium

The task of the stabilisation of the currencies after the war and the maintenance of their stability was made extremely difficult by the existence of a huge surplus of fictitious wealth. This liability weighed like a millstone on the world throughout the period of post-war stabilisation, and was largely responsible for the failure of the attempt to maintain monetary stability in the changed conditions. In particular in Great Britain—which country holds a key position in the world's economic system—the existence of excessive public debt ruled out the possibility of maintaining sterling permanently at its pre-war parity. The result of the huge public debt was a maldistribution of purchasing power which was largely the cause of the persistent post-war depression. The productive classes had to carry an unduly large class of unproductive rentiers and unemployed. This burden increased in proportion to the fall of commodity prices.

To the disequilibrium between fictitious wealth and real wealth was added the disequilibrium between exchanges as a result of the choice of the rates of stabilisation by the various countries. While Great Britain and Italy deliberately overvalued their currencies, France, Belgium and other countries stabilised theirs at a deliberately undervalued level. The result was a pressure on the overvalued currencies. Coupled with internal disequilibrium, this external disequilibrium of sterling was bound to lead to trouble sooner or later. The trend of developments in other countries was also moving rapidly towards a crisis. The burden of fictitious wealth increased considerably all over the world during the period of stability, as a result of the orgy of unproductive lending and borrowing, internal and international. Reparations and war debts, the replacement of capital destroyed by inflation, the rivalry between the lending centres, etc., were responsible for the development of a huge international floating indebtedness, in addition to the abnormally large international funded indebtedness.

(6) Maldistribution of Gold

The scarcity and maldistribution of the world's monetary gold stock provided the direct cause for the crisis. Owing to the concentration of a disproportionate amount of gold in the

United States and France, and owing to the overvaluation of sterling, Great Britain was unable to acquire and maintain a gold reserve in accordance with her internal credit requirements and with her position as the world's banker. *London* had to work with a very narrow margin of gold reserve. The British bank rate had to be kept unduly high, and in spite of this, sterling was vulnerable.

There was no chance of restoring internal or international equilibrium in the conditions existing between 1925 and 1931. Great Britain's credit resources had to be kept at a low margin in order to safeguard the international stability of the pound. As a result, British production was unable to increase to a level at which the burden of fictitious wealth would have become less unbearable. Even if in other countries conditions had been practically normal, the British disequilibrium alone would sooner or later have brought about the world crisis, owing to the importance of Great Britain in the international economic and financial system.

(7) Slump failed to readjust Disequilibrium

It was, however, developments in the United States which brought the crisis to a head. The unwarranted degree of optimism about everlasting prosperity resulted in a boom in Wall Street which brought about an increase in fictitious wealth through the fantastically high level to which stocks and shares had risen as a result of the practice of carrying securities largely with the aid of borrowed money. This bubble was bound to burst sooner or later, especially since an adequate increase of real wealth, which might have provided a justification of the rise in stocks and shares, was impossible owing to the maldistribution of purchasing power caused by excessive fictitious wealth. The Wall Street slump of 1929 brought about a severe depression in the United States, a depression which spread over Europe and the rest of the world and which culminated in the financial crisis of 1931.

To some extent the wholesale default of debtors and the wholesale failure of banks and other firms led to the liquidation of excessive fictitious wealth, but this was more than offset by the falling trend in commodity prices, which led to the increase in the burden of fictitious wealth in spite of the reduction in its nominal amount. In any case, in many countries the forced liquidation of fictitious wealth by failure and default went so far as to necessitate Government support to debtors in order to avoid disaster. In the United States in particular,

milliards of dollars were spent even before the advent of President Roosevelt in bolstering up insolvent banks and other concerns. The result of such support was, of course, an increase of the public debt, which in any case was going up owing to current budgetary deficits caused by the crisis. During the most advanced stages of the depression, a number of Governments adopted a spending programme in order to bring about reflation, and this again led to a considerable increase of fictitious wealth.

(8) Effect of Currency Depreciation and Devaluation

In the countries which had devalued or depreciated their currencies this increase was at least counteracted by the depreciation of the monetary unit. Commodity prices had recovered in these countries from their low level, and to that extent a any rate the rise in fictitious wealth was offset. In other cases, however—especially in the United States—the increase in fictitious wealth through public expenditure was much too large in proportion to the reduction of fictitious wealth through higher commodity prices. This was due, to a large degree, to the fact that a considerable part of the world was still deflating. The depreciation of currencies, coupled with reflationary expenditure, was unable to produce its full effect owing to the fact that until 1935 commodity prices in a number of countries were still falling. It is a frequently repeated accusation against countries which depreciated their currencies that in doing so they forced other countries to deflate. This argument can very well be turned round, since it was continuous deflation in countries which did not depreciate their currencies which prevented an adequate rise in commodity prices in countries which depreciated their currencies. So long as a large part of the world defended the stability of their currencies with the aid of deflation, there was but little chance for reflation in the rest of the world to produce adequate results.

The devaluation and depreciation of a number of currencies created a new state of disequilibrium in which the currencies of the Gold Bloc and its satellites remained grossly overvalued. France and the other countries of the Gold Bloc hoped to be able to restore this equilibrium by means of deflation. From time to time economy drives were enforced, both in Government expenditure and in cost of production. The result was, of course, a curtailment of purchasing power and an accentuation of the depression. The haphazard method

of deflating with the aid of credit restrictions was gradually replaced by the less orthodox and more effective method of "consistent deflation", which attempts to reduce budgetary expenditure, prices, rents, wages, etc., through Government intervention. This method was initiated in Italy, and was subsequently adopted by Germany, Belgium, France and the other members of the Gold Bloc.

(9) Limitations of Deflation

This method of self-castigation might have stood a chance of succeeding at the cost of heavy sacrifices but for the existence of excessive fictitious wealth in the countries concerned. In France and Italy the fall in commodity prices resulted in an intolerable increase in the burden of public debt, notwithstanding the reduction of interest charges through more or less open partial default in the form of forced conversion or cuts in interest services. It was the increase in the burden of fictitious wealth through the fall in commodity prices that reduced deflation *ad absurdum*. The burden of public debt made it impossible to balance the budget on a lower plane. After each series of economic measures the proportion of the debt service in the total expenditure tended to increase. It became evident to all but fanatical deflationists that the process could not continue for ever. The difficulties of balancing the budget and the necessity of assisting trade or debtors victimised by deflation set in motion reflationary forces which were bound sooner or later to defeat a deflationary policy.

The efforts of the Gold Bloc countries to resist devaluation by co-operation led to no noteworthy results. Co-operation confined itself to technical arrangements and to vague schemes of tariff concessions which never materialised. None of the Gold Bloc countries was prepared to grant any material financial support to the others, for they needed their resources for the defence of their own currencies. In the circumstances it was inevitable that the weakest link of the chain should break. This weakest link was Belgium, whose banking position was gravely affected by the deflationary depression, and whose technical position was not nearly as strong as that of the other Gold Bloc countries. The collapse of the resistance of the belga, which marked the beginning of the death-struggle of the Gold Bloc, will be described in the next chapter.

PART II

FAILURE OF DEFLATION

CHAPTER IV

THE BELGIAN DEVALUATION AND AFTER

(1) The Weakest Link in the Chain

By the end of 1934 and the beginning of 1935 the countries of the Gold Bloc had entrenched themselves to withstand a long siege. In face of the adverse pressure on their currencies, caused by trade deficits, they more or less cut down their imports to the level of their exports, and thus brought about equilibrium at a lower plane. They were struggling with the problems of their budgetary deficits and public debt, which, however, at that stage did not appear to be acute. There was a gradual decline of their gold reserves owing to the persistent outflow of foreign balances and national capital, but even this factor did not present any imminent danger. Beneath the surface of the apparent equilibrium, however, powerful currents were working towards the destruction of the Gold Bloc currencies. They were unquestionably doomed, even though they were evidently in a position to put up a prolonged resistance. Whether they were to meet their fate immediately or only in several years depended on the extent to which the nationals of these countries realised the utter hopelessness of the position. From this point of view it was evident that the breakdown of the resistance of any one of the Gold Bloc countries would have a decisive influence on public opinion in the remaining Gold Bloc countries.

Belgium provided the scene of the decisive battle which determined the fate of the whole Gold Bloc. Undoubtedly she was technically the weakest of the four countries, not only because her gold reserve was comparatively speaking smaller, but mainly because of the precarious state of her banking system. In Belgium, as in the United States, it was through the weakness of the banks that the overvaluation of the currency led to its collapse.

(2) Effect of Deflation on Belgian Trade and Banking

Ever since the depreciation of sterling, Belgium had been struggling with the overvaluation of her currency. Her indus-

tries are to a large degree competitive with British industries, and therefore felt the effect of the undervalued pound more keenly than those of the other countries of the Gold Bloc. Notwithstanding the ruthless cutting down of cost of production, Belgian exporters found it difficult to hold their ground. Belgium is one of the few countries where export trade plays an even more important part in the nation's economic system than in Great Britain. Being the most densely populated area in Europe, it is of vital importance that she should keep up a reasonably large export trade in order to be able to feed her population. Her whole industrial system is based on export trade. Consequently the decline of Belgian exports led to a very high degree of depression in Belgian trade. It is true that through cutting down imports to the lower level of exports the direct adverse effect of the decline in the latter upon the exchange was avoided. The overvaluation of the belga undermined, however, the stability of the currency through indirect channels.

Belgium is one of the continental countries where banks and industries have been very closely interrelated. In some instances banks controlled industries, and in other instances industries controlled banks. Whichever was the case, banks were inevitably affected by the industrial depression caused by the fall in export trade. They became hopelessly immobilised and in some instances it was necessary to carry out drastic reconstruction schemes which, however, barely touched the surface. In 1934, legislation was passed compelling the banks to divorce themselves from industries and to relinquish their industrial assets to a Government-controlled company established for that purpose. This reorganisation scheme came, however, somewhat late in the day. It failed to restore confidence in the banks, and the process of reorganisation did not proceed sufficiently far before the advent of the acute crisis.

(3) Flight from the Belga

The flight from the belga, which was going on throughout 1933 and 1934, and which assumed spectacular dimensions at the end of 1934 and early in 1935, was due as much to fears of a devaluation as to distrust in the banks. Deposits were withdrawn on an extensive scale, and the banks' resources were dwindling down. This made it increasingly difficult to meet even the reduced credit requirements of trade, and added to the causes of industrial depression. It was evident

that this state of affairs could not continue for very long. In the autumn of 1934 a speculative attack was directed against the belga, and even though the National Bank was able to withstand the strain, it lost much of its gold stock. In order to cope with the emergency, the Government of M. Theunis was given plenary powers to deal with the situation. Economy measures were enforced, but not to a sufficient extent to balance the budget, which indeed was an impossible task amidst the prevailing depression. The movement in favour of devaluation was gaining ground. One of the best-known devaluationists, M. Francqui, was included in the new Cabinet, but once a member of the Government he discarded his devaluationist views. None of the politicians dared to face the decision to devalue, even though they were aware that it was inevitable. Evidently the advent of a sweeping panic was necessary to make devaluation politically possible.

The immediate cause for the acute crisis of March 1935 was the fresh depreciation of sterling. Throughout 1934 the repatriation of American capital and other reasons resulted in a steady adverse pressure on sterling and the gold reserve of the Exchange Equalisation Account became depleted. When in March 1935 an adverse tendency developed, the Exchange Equalisation account was no longer in a position to counteract it, and the sterling–dollar rate was allowed to depreciate to 4·71. This new fall further aggravated the position of Belgian export trade and provided the last straw to break the resistance of the belga.

(4) The Climax

An intense wave of pessimism developed towards the middle of March, and simultaneously with speculative forward selling of belgas, Belgian capital left the country on a large scale. At the same time the British Government, to counteract the adverse undertone of sterling, sought to reduce the import of steel, thereby increasing the difficulties of Belgium's main export industry. It was evident that the resistance of the belga was drawing to its end. In fact, the Belgian authorities had unofficially sounded London to ascertain the British Government's attitude in case of a devaluation of the belga. They hoped to be able to obtain assurance that it would not be followed by a corresponding depreciation of sterling. The British authorities were not, however, in a position to give such assurance, even if they had had any intention of relinquishing their freedom of action. With their gold reserve

depleted, they could not possibly have promised to hold sterling irrespective of any increase of selling pressure upon it. All that they could promise was that the mere fact of the devaluation of the belga would not be followed by any deliberate depreciation of sterling as a measure of reprisal. Dissatisfied with this answer, the Belgian Government sounded Paris about the possibility of active assistance. M. Theunis came back, however, empty-handed, which fact did not prevent one of the members of his Cabinet from declaring in public that " the belga was saved ".

The pressure on the belga began to assume spectacular proportions. It appeared as if M. Theunis intended to resort to the orthodox remedy of enforcing fresh budgetary cuts in order to restore confidence. To that end he sought and obtained a renewal of his plenary powers to deal with the financial situation. It was difficult to imagine, however, how further deflation could possibly have been successful. The working classes were becoming increasingly restive in face of attempts at further cuts in their wages, and any wholesale deflationary measures would have led to a series of grave disturbances. Above all, the banking situation was growing increasingly menacing. The withdrawal of deposits continued on an increasing scale, and collapse threatened the whole banking system.

(5) The Political Crisis

In these conditions M. Theunis was faced with the alternatives of making a desperate effort to defend the belga the best way he could, or accepting the ruling of fate and devaluing. Both courses were fraught with danger and appeared to be political suicide. Accordingly he chose a third alternative. He ran away. In the middle of the acute panic the Government resigned, leaving it to the young and inexperienced King Leopold to cope with the desperate situation the best way he could. Almost the last act of the outgoing Government was an emphatic denial that the belga was ever likely to be devalued.

An " interregnum " of about a week followed the Government's resignation. It appeared to be an impossible task to form a Government with adequate political backing in the panicky conditions prevailing in Belgium. The various political parties were playing for position, but none of them wanted to assume the responsibility for the inevitable devaluation. Meanwhile the belga took the solution into its own hands.

Since after the Government's resignation its defence relaxed, it underwent a sharp depreciation. As a result the panic attained its climax during the last days of March. The banks were paying out deposits to the limit of their capacity. It is said that on March 30 the cash supplies of the leading Belgian banks became reduced to a negligible figure. The gold reserve of the National Bank fell heavily and the figure of its rediscounts rose rapidly. The situation was desperate in every way.

(6) M. van Zeeland takes Charge

It was amidst these conditions that M. Paul van Zeeland took charge of the Government. Not being a professional politician but a banker—until March 1935 he was a Director of the National Bank of Belgium—he had no political axe to grind, and was willing to face the political consequences of a decision to devalue. He fully realised the necessity for such a step and was public-spirited enough to assume responsibility for it.

Indeed, M. van Zeeland is one of the very few fine characters and strong and able statesmen that came to the surface during the monetary turmoil of 1931–6. He was ready with his programme, and as soon as he obtained the necessary political support he lost no time in putting it into operation. As soon as his Government was formed, with the support of the three leading political parties, he rushed through Parliament legislation for the devaluation of the belga to the extent of 28 per cent. Although it is understood that he would have preferred Belgium to join the Sterling Bloc, most of his supporters insisted that Belgium should remain linked to gold, and he had to make this concession to political requirements. Apart from this, he proceeded with the application of his programme irrespective of the opposition, protests and intrigues it provoked.

(7) Devaluation

On March 30 the devaluation of the belga was announced. It must have come as a great relief after the strain of the preceding fortnight. Many quarters in Belgium were determined, however, to make political capital out of the devaluation, and worked up frantic agitation demanding the punishment of the culprits responsible for it. Indeed, a large section of Belgian public opinion was simply revelling in the feeling

that there was something dishonest and shameful in the devaluation of the belga. They insisted that the nation should feel guilty about it, and that scapegoats should be found for the purpose of atonement. An inquiry, an inquest, an inquisition was demanded, and accordingly a committee was set up to ascertain who had benefited by the devaluation and who was responsible for working up the campaign in its favour. The inquiry which began with much publicity petered out before very long. The investigation of bank accounts revealed the fact that almost everybody who was somebody had funds transferred abroad. The list of owners of foreign accounts included such highly placed names that its publication would have led to a first-class political crisis and the collapse of the coalition on which the Government was based. Members of all the parties were compromised, and none of them insisted therefore on proceeding much further. The whole matter was hushed up and forgotten.

In any case, within a few days of the devaluation of the belga its beneficial effects became too evident to be denied even by the most fanatical critics of devaluation. The recovery that followed the crisis of March appeared little short of miraculous. The banking situation changed for the better overnight. As a result of the wholesale repatriation of capital, the volume of deposits increased, and confidence in the solvency of banks returned. Trade activity increased as a result of better export possibilities and the moderate rising trend of prices. This again reacted favourably on the position of the banks. Within a few months after devaluation, Belgium ceased to have a banking problem. Trade benefited by the cheap and plentiful money that became available following upon the repatriation of capital. There was in addition a heavy influx of foreign funds from abroad, since the belga inspired confidence at its devalued level. The technical position of the National Bank improved beyond recognition within a few months, and the only problem that caused it some difficulty was that of the *embarras de richesse* brought about by an excessive influx of funds.

Much to the disappointment of anti-devaluationists in Belgium and elsewhere, the devaluation of the belga was not followed by disaster. Indeed, the operation was highly successful in every way. Even though anti-devaluationists in the countries of the Gold Bloc did their best to minimise its favourable results and over-emphasise its slight disadvantages, it was clear to the impartial observer that Belgium had no

reason to regret having taken the obvious course. M. van Zeeland has rendered a service to his country and to the world in general by providing an example of highly successful devaluation.

CHAPTER V

ATTACK ON THE GUILDER

(1) Repercussions of the Belgian Devaluation upon the Gold Bloc

While the devaluation of the belga ended with one stroke the crisis in Belgium, the other side of the picture was an aggravation of the difficulties of the remaining Gold Bloc countries. It provided the signal for an acute attack on the gold currencies, which one after the other became the storm centre. The devaluation of the belga stimulated the flight of capital from France, Holland and Switzerland, and also the speculative selling of French francs, Swiss francs and guilders. This was only natural. It stood to reason that sooner or later the other members of the Gold Bloc would share Belgium's fate. It is true that the French, Dutch and Swiss Press and politicians did their utmost to emphasise that conditions in their respective countries were totally different, but the basic fact remained that their currencies were overvalued at least to the same extent as the belga had been before its devaluation. Nor could the public be expected to take these denials too seriously, considering that the Belgian authorities and the Press had denied that there was any intention to devalue the belga a few days before it actually happened. The close relations which members of the Gold Bloc sought to establish with each other proved to be a boomerang after the devaluation of the belga, for the fact that one of the members of the Gold Bloc had devalued strengthened the belief that the rest of the group would follow suit.

Last, but by no means least, speculators derived encouragement from the substantial profit they had made on their bear operations in belgas. They grew bold and even reckless, and were prepared to run risks in the hope of repeating their coup by "bearing" the remaining gold currencies. There is nothing to be said in excuse for their activities. Undoubtedly speculators in foreign exchanges are the dregs of humanity, who deserve individually every contempt. Collectively, however, they acted merely as the executive hand of underlying

tendencies. Even in the absence of speculation the flight of national capital would in itself have been sufficient to undermine the stability of the Gold Bloc currencies. Even in the absence of such a flight of capital, the fact of the disequilibrium would in the long run have produced the same result. The rats that were leaving the sinking ships and the gamblers who were seeking to make tainted profits out of the distress of nations had merely accelerated the process. While individually they deserved all the criticism that was directed against them, as a whole they served a useful purpose by shortening the duration of the agony.

(2) Why Holland was First to be Affected

The first attack following the devaluation of the belga was directed against the Dutch guilder. Even in 1933 the guilder had been subject to an attack after the depreciation of the dollar, but the Dutch authorities found no difficulty in resisting it by resorting to the orthodox method of high bank rate and by discouraging speculative operations. On this occasion the blow caused by international monetary developments was nearer home, both geographically and economically. Even though Belgium is mainly industrial while Holland is mainly agricultural and commercial, to a large degree the two countries are competitors. The reduction of port charges and railway freights through the devaluation of the belga diverted much transit trade from Rotterdam to Antwerp. The Belgian market for Dutch agricultural products narrowed down as a result of the higher price for the imported products.

Moreover, the existence of a currency which was on a gold basis and which was no longer vulnerable provided a strong temptation for Dutch people to cross the border and transfer capital to Brussels. From the very outset it was taken for granted that among the remaining Gold Bloc countries Holland would be affected by the devaluation of the belga to a particularly high degree. As a result, such foreign balances as were still in Amsterdam were promptly transferred abroad, and there was also a heavy outflow of Dutch national capital.

(3) The Dutch Devaluationist Movement

In itself the economic situation of Holland was incomparably less unfavourable than that of Belgium. Even though the country was suffering through the depression of her

colonial trade, due to overvalued currency, the increase of produce prices since the suspension of the gold standard in the United States provided some relief. Although the budget was unbalanced, the deficit was by no means unmanageable. Nor was the public debt excessive, and the Dutch Government enjoyed good borrowing facilities. What is more, the Dutch banking system was safe and sound. Having liquidated the greater part of their Central European commitments, the leading Dutch banks were still in a position to withstand the prolonged depression.

Notwithstanding this, there was a strong wave of pessimism over the prospects of the guilder during April and May 1935. For one thing, the public in Holland and abroad was not certain whether after the Belgian devaluation the Dutch Government would not deliberately change its monetary policy and follow the Belgian example. Notwithstanding frequent denials, the possibility of a surprise in this respect was very much present in the minds of the public, and of the markets: all the more so as the number of partisans of devaluation in Holland increased considerably after the devaluation of the belga. It was generally known that influential interests in Rotterdam were doing their best to force the Government's hand, so as to obviate the decline of the port's traffic through the increased competitive capacity of Antwerp. Other commercial, industrial, agricultural and colonial interests were mobilising their connections to the same end.

(4) Dr. Colijn's Resistance to Devaluation

Those, however, who supposed that the Dutch Prime Minister, Dr. Colijn, would yield to pressure reckoned without his stubborn character. Although a modern statesman, Dr. Colijn in his unbending stubbornness shows much similarity to the character of Kruger. Both were equally uncompromising, and prepared to jeopardise the real interests of their countries rather than yield an inch. Had Dr. Colijn grasped the lesson of the belga, and had he had the moral courage to revise his policy, it would have saved much unnecessary delay in the adjustment of the Gold Bloc currencies which eventually proved inevitable. Indeed, he is known to have expressed the opinion late in 1935 that it would have been wiser for Holland to follow the British example immediately after the suspension of the gold standard in Great Britain, but that, having resisted for four years, she might as well continue resisting.

Considerations of a personal character may also have played a certain part in determining Dr. Colijn's attitude towards devaluation. In 1933 during the London Economic Conference he was easily the strongest man among the representatives of the Gold Bloc countries in London. Indeed, the establishment of the Gold Bloc was largely the result of his initiative. It must have been flattering to a Dutch statesman to feel that, through the strength of his personality, his country had assumed the lead once more in world history, even if it was only in the sphere of finance. Human nature being what it is, it would perhaps have been too much to expect him to become instrumental in the demolition of the edifice which he himself had built, and in which he took such pride.

(5) Considerations of Prestige

There was also another aspect of the problem of the Dutch attitude towards devaluation. After the depreciation of sterling, the dollar, and the Scandinavian currencies, the guilder and the Swiss franc were the only remaining currencies which were still at their pre-war parities. Even though the French franc was resisting devaluation, it had already been devalued once in 1928. It was considered a matter of prestige, both in Holland and in Switzerland, that their currency should be the last to yield to the world-wide pressure for devaluation. Had Switzerland devalued in April 1935, possibly Holland would willingly have followed her example, having had the satisfaction of holding out longer than Switzerland. It may appear strange that hard-headed, practical nations such as the Dutch and the Swiss should be influenced by such childish considerations, but he who has never been elated by the victory of his nationals at some international sports event, or who has not been disappointed over the failure of the nation's fast liner to capture or retain the Blue Riband of the Atlantic, should throw the first stone.

However it may be, the Dutch Government decided to resist after the devaluation of the belga, and its decision was put into practice by the Netherlands Bank with an energy and efficiency worthy of a better cause. The methods applied were, to begin with, strictly orthodox. It was only later, after the first acute attack came to an end, and after M. Laval began to experiment in heterodox deflation, that Dr. Colijn decided to follow his example.

(6) Flight from the Guilder

German and other foreign capital was the first to leave the country, for foreigners are always apt to view the prospects of a currency with more pessimism than the nationals of the country concerned; moreover, they also stand to lose more through devaluation. But in April and May 1936 Dutch people themselves began to play for safety. Moreover, the wide discount on the forward guilder made the transfer of funds to foreign centres through interest arbitrage rather profitable. As a result of the selling pressure on the guilder, the Netherlands Bank in April lost gold to the amount of 168 million guilders. This led to a contraction of credit resources, bankers' deposits with the Central Bank declining in April by 73 million guilders. As this did not produce the full deflationary effect desired by the Dutch authorities, the Bank rate was raised from $2\frac{1}{2}$ to $4\frac{1}{2}$ per cent early in April. This in itself would not have made much difference, as in the changed conditions the higher bank rate was unable to prevent the withdrawal of funds, or to attract funds from abroad. Nor did it create a sufficient monetary stringency to put a stop to the outflow of capital. Its main object was to discourage speculative pressure on the guilder, by making the borrowing of guilders more difficult. To the same end, Dutch banks were requested by the Netherlands Bank to abstain from granting credits to foreign borrowers, and to abstain from operating in forward guilders except for genuine commercial purposes. In time of crisis, such a request from the Central Bank amounts to a command. Moreover, at the Netherlands Bank's request the Dutch banks deliberately widened the discount of forward guilders. In doing so they aimed at discouraging speculative short selling, by increasing the cost and the risk attached to the operation. There is much to be said for and against these technical measures as a method of defending a currency.

(7) End of Selling Pressure

The selling pressure on the guilder came to an end early in May, possibly because of these measures, possibly in spite of them. In face of a really sweeping flight of capital they would have been useless. In the absence of such a flight of capital, speculative pressure in itself is not worth bothering about if the technical position of the Central Bank is as strong as that of the Netherlands Bank was in April 1935. As a

gesture the technical measures taken may have been useful, in that they indicated the determination of the Dutch authorities to resist the pressure.

The main reason for the termination of the attack against the guilder was, however, that the storm centre shifted from Holland to Switzerland. As we shall see in the next chapter, the organisation of a Referendum to decide upon the adoption of proposals of an inflationary character brought about an acute wave of pessimism towards the Swiss franc in April and May 1935. It was this wave of pessimism that diverted the attention of speculators from the Dutch guilder to the Swiss franc. Speculators realised that the technical position of the guilder was strong enough to continue to resist devaluation if the authorities wanted to do so. They therefore transferred their attention to the Swiss franc and subsequently to the French franc, leaving guilders more or less alone until later in the summer. There was very little loss of gold in May and June, though the movement was resumed in July. The series of minor crises of the guilder that occurred during summer and the early autumn of 1935 will be dealt with in Chapter X. Meanwhile we shall describe the crisis of the Swiss franc and of the French franc following upon the devaluation of the belga.

CHAPTER VI

ATTACK ON THE SWISS FRANC

(1) Consequences of Overvaluation

The war left Switzerland, together with other neutral countries, in a very favourable financial position. Although the country had its share of post-war boom and slump, and after 1929 it was inevitably hit by the world economic crisis, until 1931 it succeeded in retaining a reasonable degree of prosperity. The technical position of the Swiss franc remained remarkably strong even during the depression. Throughout 1932 the note circulation was covered to an extent of some 125 per cent by gold and Foreign Exchanges. The ratio of the metallic reserve to notes and sight liabilities was between 90 and 100 per cent. This high rate was, however, a necessary precaution, considering that ever since 1914 Switzerland had served as one of the principal refuges for foreign funds. During the war many people from various belligerent countries who had sufficient foresight to realise the political and financial consequences of the upheaval transferred some of their money to Switzerland. After the war the flight from the French franc, Belgian franc, lira and Central European currencies resulted in a heavy influx of foreign deposits to Switzerland. After stabilisation, some of these funds were repatriated, but since confidence was not completely restored, much was left behind. Moreover, high direct taxation in the various countries, not least in Great Britain, was also responsible for the transfer of new kinds of refugee funds. Most of these funds were subject to withdrawal at short notice, and the Swiss authorities were right in providing for the possibility of sudden withdrawals by keeping the gold reserve well above the legal minimum requirements.

The overvaluation of the currency from 1931 onward dealt a severe blow to Swiss trade. It reduced tourist spendings, which were already severely reduced in consequence of the world-wide depression. Switzerland, like other countries which maintained their currencies at their old parity, had to embark upon a policy of deflation, which was by no means

easy. Almost for the first time in its history the country was experiencing grave labour disturbances in 1934. Its exporting industries suffered through the overvaluation of the franc and the heavy fall in the price of agricultural products hit the agricultural population hard.

(2) Banking Difficulties

The Swiss banking situation also gave rise to growing concern. Apart from the inevitable repercussions of adverse trade conditions upon the earnings and liquidity of the banks, the latter were hit hard by the German crisis of 1931. They lent disproportionately large parts of their resources to Germany and other central European countries, and these loans became hopelessly immobilised with the moratorium on external payments and the subsequent standstill agreements. In many instances the amount of German and other Central European frozen credits was well in excess of the banks' capital and reserves. So long as there was no wholesale withdrawal of deposits, this caused no visible inconvenience, and the banks were in no great hurry to remedy this state of affairs. While American, Dutch, French and Italian banking creditors of Germany were reducing their standstill commitments by cutting relatively moderate losses, Swiss banks were not prepared to make such sacrifices. Consequently, when the crisis of the Swiss franc came in 1935, they proved to be particularly vulnerable.

There was another reason why the banking situation proved to be the weak spot in the armour of defence of the Swiss franc. The Swiss system of time deposits assumes largely the form of issuing medium-term debenture bonds over the counter, throughout the year whenever there is demand for it. These debentures bonds consequently mature day after day. The disadvantage of this system compared with ordinary time deposits is that holders of debenture bonds need not take the initiative if they want to withdraw their funds. The debenture bonds are repayable automatically on maturity. In the case of time deposits, however, the holders have to take the initiative and withdraw their funds on maturity, and this they may be reluctant to do at times of uncertainty, owing to their well-established relations with the banks.

(3) Flight of Foreign Capital

Until April 1935 the Swiss franc suffered comparatively little through its overvaluation. There were a few relatively

moderate attacks, which the National Bank was able to resist without even raising its bank rate. After the devaluation of the belga, however, there was a wholesale withdrawal of foreign balances, which were transferred mostly to London or New York. As in the case of Holland, it was assumed that the defection of Belgium would bring about the collapse of the whole Gold Bloc at an early date. From the point of view of the National Bank's position the withdrawal of foreign balances would not in itself have caused grave inconvenience, since, as we have seen above, there was an ample safety margin of gold reserve available for meeting such pressure. In any case, a large proportion of foreign balances was not likely to be withdrawn in any circumstances. These balances represented holdings by Germans and nationals of other countries with exchange restrictions who were not in a position to enter into correspondence for the transfer of their balances without running the risk of being found out by their Governments and prosecuted for violating the exchange regulations. They preferred to expose themselves to a depreciation of the Swiss franc rather than run the risk of confiscation and imprisonment.

Taking this into consideration, the Swiss authorities could have afforded to view the withdrawal of foreign balances with comparative equanimity, but for the fact that in addition to affecting the gold reserve these withdrawals also affected the banking position. They resulted in the rapid depletion of the banks' cash resources, and a stage was reached at which the banks had to liquidate some of their assets in order to meet withdrawals. The choice was between cutting down their Swiss credits or liquidating their frozen German credits at a loss ranging between 35 and 50 per cent.

The choice was by no means easy. In the case of several banks, such liquidations would have wiped out the whole visible and invisible reserves and a large part of the share capital. On the other hand, it was equally difficult to mobilise funds invested in loans to Swiss customers. Part of these loans were frozen, and part of them became frozen the moment repayment was demanded. As is usually the case, it was only the best type of loans that could be liquidated, and the banks were naturally reluctant to antagonise and embarrass their best customers. Confronted with this dilemma, several of the leading Swiss banks preferred to avoid taking a decision, and allowed their cash reserve to decline to a dangerously low level in the hope that the pressure would soon come to an end.

(4) Flight of Swiss Capital

The pressure did not, however, come to an end, for the simple reason that in addition to foreign funds, Swiss capital also began to leave the country on an extensive scale. This was due not so much to fears of a devaluation as to the agitation initiated in favour of drastic changes in the Federal Constitution to enable the Government to embark upon wholesale reflation through public works and social expenditure. The scheme, which was elaborated by the Belgian economist, de Man, did not actually include devaluation, but it was evident that, should it be adopted, the resistance of the Swiss franc would weaken considerably. For one thing, the scheme included provisions forbidding any further reductions of wages and of the prices of agricultural products. Since the Swiss price level was out of equilibrium with the world level, and since it appeared as though the other countries of the Gold Bloc would continue to deflate, it was expected that the prevention of further deflation in Switzerland would perpetuate and even accentuate the existing disequilibrium. The possibility of a majority in favour of the amendment of the Constitution at the Referendum of June 2, 1935, resulted in the flight of a certain amount of Swiss capital in addition to the outflow of foreign balances. This fact was stoutly denied by the Swiss authorities, bankers, and newspapers, but there was ample evidence of it in London.

(5) Speculation

There was, needless to say, a certain amount of speculative activity against the Swiss franc. The importance of the speculative attack among the causes of the weakness of the exchange was grossly exaggerated by the Swiss Press and by official Swiss quarters, so as to divert attention from the fundamental factors working against the Swiss franc. The leading Swiss newspapers published day by day strongly-worded articles showering torrents of abuse upon anyone who ventured to suggest that the franc was vulnerable. Swiss bankers in their spare time, when they were not too busy exporting Swiss capital abroad, protested vigorously against the calumny that Swiss capital was being exported. They repeated to boredom that speculation, and speculation alone, was to blame for all troubles. Their outbursts against speculators, and those of their Dutch colleagues, were all the stranger since it is a well-known fact that ever since 1914 Holland and

Switzerland have fulfilled the rôles of the world's gambling dens in exchanges. Every currency in turn was attacked in either or both of these countries. Amsterdam and Zurich played a prominent part in the mark gamble of 1923; in the attack on the franc in 1924, and subsequent years; bears in lira and Belgian francs were welcomed with open arms by Swiss and Dutch bankers, who regularly acted as agents for the speculative operations of countries where the existence of exchange restrictions precluded the possibility of gambling in the local market. Even during the period of stabilisation the peseta was attacked mainly in the Swiss market. Some of the Dutch and Swiss banks themselves did not mind taking a hand at times on their own account.

Neither the Swiss and Dutch newspapers nor the bankers, nor even the Central Banks and Governments of the two countries, found any fault with these subversive activities and found no fault with pocketing the handsome profits derived from them. It was only when speculators began to pay attention to the franc and the guilder that the destructive character and immorality of their work was suddenly discovered. It is charitable to presume that they disapproved of speculation all the time, so that when in April and May 1935 they gave vent to their disapproval it was the accumulated criticism of twenty years that found expression in their attacks, in the same way that all the sounds which became frozen into Baron Münchhausen's trumpet suddenly became released and burst out when the frost began to thaw. A less charitable assumption is that these gentlemen did not mind speculation as such. What they did not like was to be speculated against.

(6) The British Attitude

"Perfidious Albion" had, needless to say, its full share of the attacks, especially as several British newspapers made no secret of their conviction that the devaluation of the currencies of the Gold Bloc was a mere question of time, and that, what was more, it was to the interest of the Gold Bloc countries to devalue as soon as possible instead of prolonging their futile resistance. It was suggested in Swiss quarters that British interests sought deliberately to undermine the stability of the Gold Bloc currencies for fear that, should they escape devaluation, London's supremacy and prestige would suffer in the long run. The fact of the matter was that London easily recovered its supremacy from 1932 onwards notwithstanding the fact that sterling depreciated and ceased to be linked with

gold. The flight to the pound year after year was sufficient evidence of the extent to which London commanded respect. There was no need to provoke the devaluation of any other currencies to that end. Apart from any other reason, the standing of a financial centre depends not so much upon past record as upon present position and future prospects. During 1929 to 1931, Paris overshadowed London, for in spite of the recent devaluation the franc inspired more confidence than sterling did, notwithstanding the return of the latter to its pre-war parity.

Indeed, it was to the interest of London's supremacy as the world's banking centre that the Gold Bloc currencies should remain perpetually overvalued, because this would have secured London the advantage of a currency which was not considered vulnerable. Nor was it desirable from the point of view of British exporters to bring the Gold Bloc countries off their old parities, as in doing so the position of the rivals of British merchants was to be improved. Notwithstanding this, British Press, banking, and even official circles were in favour of an early devaluation of the Gold bloc currencies, simply because they considered the prosperity of the Gold Bloc countries essential for the return of world prosperity.

In many quarters in Switzerland and elsewhere it was duly realised that the devaluation of these currencies would be against obvious British interests. This, however, failed to improve their opinion of the British attitude. Since on the surface Great Britain appeared to be prompted by entirely unselfish motives, they suspected some very Machiavellian motive beneath the surface.

(7) Defence of the Franc

As a result of the flight of foreign and Swiss capital, the Swiss National Bank's gold stock underwent a sharp decline. From 1,910 million francs at the end of 1934, it dropped to 1,193 million francs by the end of May 1935. Even so, the reserve ratio remained very high at 77½ per cent to all sight liabilities. The technical position was, for the time being, unassailable, but a few more crises such as that of May would have wiped out the safety margin.

While the Dutch and French authorities sought to protect the gold reserve by means of a high bank rate, the Swiss authorities were enlightened enough—strange as this may sound in face of their orthodox dogmatism on the matter of devaluation—to realise the futility of such a measure. As a

matter of form, the Swiss National Bank raised its rediscount rate to 2½ per cent early in May, but that was all. They did not indulge in the farce, witnessed in France time and again during 1935–6, of restricting credit with one hand and expanding it with the other, so as to safeguard the banks and trade against the effect of credit restriction. The fact that the Swiss franc got over the attacks in 1935 much more easily than either the French franc or the guilder, in spite of the low bank rate, should go a long way towards casting doubt upon the cult of bank-rate worship.

(8) The Crisis Subsides

The flight from the Swiss franc and the speculative attack continued until the end of May. Towards the end of the month the storm-centre shifted over to France, owing to the French political crisis, but it was not until the result of the Referendum of June 2 became known that the adverse pressure on the Swiss franc relaxed. The de Man proposals were defeated at the Referendum, but their opponents had little reason to be triumphant, for the very strong minority of 42 per cent of the voters were in its favour. The fact that such a considerable section of the population was against deflation and in favour of radical reflationary measures left behind a vague feeling of uneasiness. Even though the Swiss franc recovered, its acute crisis was followed by chronic withdrawals of deposits for months afterwards. As we shall see in Chapter XI, the banking troubles that developed during the summer and autumn of 1935 stimulated the pessimism regarding the Swiss franc and the outflow of funds caused by this pessimism accentuated in turn the banking difficulties.

By the beginning of June it appeared as if both Dutch guilder and Swiss franc had weathered the immediate storm following upon the devaluation of the belga. It became evident that in spite of their inherent weakness they were in a position to put up a prolonged resistance. It was, however, the development of a major crisis in the French franc that diverted attention from the Swiss franc, just as the crisis of the latter had brought relief to the guilder a month earlier. The storm-centre, after having moved from Brussels to Amsterdam and thence to Zurich, had now shifted to Paris.

CHAPTER VII

THE FIRST FRENCH CRISIS

(1) France during 1928–31

The crises of the guilder and of the Swiss franc were mere incidents in the great fight of the Gold Bloc currencies that began with the devaluation of the belga. It was in France that the fate of the Gold Bloc was to be decided. Admittedly the devaluation of either of the minor currencies would have aggravated the position of the remaining Gold Bloc currencies, possibly to an intolerable degree. But the chances were that the guilder and the Swiss franc would not collapse before the French franc, so that it was upon the resistance of the latter that the fate of the Gold Bloc depended.

In order to understand the French position in 1935, it is necessary to cast a glance upon the financial evolution of France during the years that preceded the crisis. As a result of the undervaluation of the franc in 1928, the technical position of the Bank of France became remarkably strong, thanks to a series of favourable trade balances, to the repatriation of French capital, and to some extent to the influx of foreign funds to the Paris financial centre. In possession of a large gold reserve and of abnormally large official sterling and dollar balances, the French monetary authorities assumed an almost dictatorial position in the sphere of international finance. The rôle they played in this respect was described in detail in my earlier books, published during 1931–4. The financial supremacy of France was incontestable until the suspension of the gold standard in Great Britain in 1931. Behind the shelter of financial power, trade in France was highly prosperous. Even the Wall Street slump and the subsequent depression were unable to affect France's trade materially. While unemployment was increasing to an alarming degree throughout the world, France continued to work almost to the full limit of her capacity.

(2) The Overvalued Franc

The depreciation of sterling and a number of other currencies dealt a severe blow to French financial power and prosperity.

The franc became overvalued and the technical strength of the Bank of France had to be used for defensive purposes. There was a series of banking crises towards the end of 1931 and through 1932. The budget, which for years following upon M. Poincaré's reforms had closed with a substantial surplus, became once more unbalanced, and year after year many milliards had to be added to the French public debt, which increased to well over 300 milliard francs. With the price level falling and incomes shrinking, it became increasingly difficult to raise additional revenue by means of taxation, and such attempts as were made from time to time to balance the Budget consisted mainly of economy drives which, in so far as they were successful, aggravated the deflationary depression. After the depreciation of the dollar the overvaluation of the franc became even more pronounced, especially as sterling was also inclined to depreciate further.

The economic depression gave rise to political unrest culminating in the riots of February 1934. Even though the Governments of National Union which followed each other during 1934 and 1935 succeeded in avoiding a recurrence of these riots on a large scale, the country was evidently seething with discontent and the internal political situation appeared to be essentially unstable. Nor had the economic and financial situation shown any signs of improving. It is true that under M. Doumergue drastic cuts were enforced in public expenditure. The result obtained was, however, a mere drop in the ocean of growing deficit, and in any case the deflation provoked by the cuts was followed by a contraction of revenue. Within a few months the achievements towards the reduction of the deficit were cancelled out.

Notwithstanding all this, until 1935 the majority of people did not suspect the franc. It seemed inconceivable that a country with such a huge gold reserve as that of France, amounting to 80 per cent of the note issue and sight liabilities, should ever be forced off gold, or that its Government should ever decide to resort to devaluing the currency without being forced to do it. By 1934 a certain degree of internal economic and financial stability appeared to have been achieved. The acute banking crisis came to an end, and since most foreign balances had been withdrawn the franc appeared to be less vulnerable. The economic depression was far from intolerable, and even though the situation was slowly and steadily deteriorating, it appeared as though it would be many years before the technical position of the franc became seriously undermined.

(3) M. Flandin's Reflationary Policy

Those, however, who saw beneath the surface realised that the franc was doomed. The budgetary disease was incurable, for it was evidently politically, economically and financially impossible to cut expenditure to a sufficient extent to restore equilibrium. Nor was it possible to reduce cost of production and price level to any material degree. By the end of 1934 France was approaching the stage beyond which deflation was bound to defeat its object and to bring reflationary forces into existence. M. Flandin, who followed M. Doumergue as head of the Government of National Union, realised that it was impossible to continue the deflationary policy of his predecessors. Accordingly he decided to embark upon a policy of reflation. Although in his heart of hearts he was a devaluationist, he thought that politically it would be impossible for him to carry out a devaluation at that stage. He did, therefore, what he considered the next best thing and sought to reflate with the aid of a deliberate policy of credit expansion.

To that end, at the beginning of 1935 M. Flandin removed the ultra-orthodox Governor of the Bank of France, M. Moret, and replaced him by his own nominee, M. Tannery, who took over the Governorship with the object of executing M. Flandin's policy of expansion. The Bank of France was to grant credit more freely, especially through the discounting or rediscounting of Treasury bills. The object of this policy was twofold. Although M. Flandin had it in mind to bring about a trade revival on the British pattern with the aid of cheap and plentiful money, he also meant to make a virtue of necessity by providing means for direct or indirect Government borrowing from the Central Bank to meet the budgetary deficit.

(4) Treasury and Bank of France

There was indeed no other way of raising the funds required by the Treasury. After M. Doumergue's economic measures had failed to produce any lasting results, it was evidently futile to attempt to make any further cuts, which in any case were considered politically risky. Nor was the French Treasury in a position to cover the deficit by means of normal borrowing from the public. By that time the wave of distrust had become stronger, and the public was not at all keen on taking up more Government securities. Indeed, investors were sellers rather than buyers, and the *Caisse de Depôts et de Consignations* had to use all its available resources to absorb the Government

loans coming on the market. In addition to investing large amounts in Government bonds, the banks were induced to take over large amounts of Treasury bills for which there was practically no market, but by the end of 1934 they reached their saturation point. It was impossible for them to absorb any more Treasury bills without endangering their liquidity. To overcome this difficulty, M. Flandin wanted the Bank of France to undertake to rediscount Treasury bills freely and without limitation. It was with this object in view that M. Tannery was nominated to succeed M. Moret.

Before very long M. Flandin had to realise, however, that his scheme was obstructed by the interests that controlled the Bank of France. Even if he was able to replace the Governor, he was unable to replace the Regency Council—the representatives of those famous "Two Hundred Families" who had the exclusive right to vote at the shareholders' meetings and who controlled the destinies of the Bank. Some of the Regents, especially MM. de Wendel and de Rothschild, were determined to oppose M. Flandin's departure from monetary orthodoxy. They were wholeheartedly supported by the prominent officials of the Bank. Before very long M. Tannery himself deserted his chief and became the wholehearted supporter of the policy advocated by the Regents. M. Flandin's schemes were shelved and only very inadequate arrangements were made for granting short loans up to 30 days on the security of Treasury bills. While on principle the Bank of France was at liberty to rediscount Treasury bills, in practice this was not done to any extent.

(5) Dictatorship of the "200 Families"

What was the object of this attitude on the part of the *haute finance* of Paris? In the light of subsequent events their shortsightedness must appear amazing, and is comparable only with that of the aristocracy under the *ancien régime*, who did not realise until it was too late that their behaviour was bringing the deluge nearer and nearer. A few financiers hoped that they would be able to control the Government's policy by keeping a tight hold upon the purse-string. The Treasury was in difficulties and was unable to meet its liabilities without the aid of the Bank of France. The Bank of France was prepared to assist the Treasury—at a price. The price was the continuation of a ruthless deflationary policy, the balancing of the budget by means of further economic measures. The bankers and industrialists who advised this policy failed to realise that

deflation had reduced itself *ad absurdum*. They thought that if only Government and Parliament could be compelled to reduce expenditure, and if their action could be followed up by a wholesale cut in wages, budgetary and economic disequilibrium would disappear. To that end they decided to refuse to assist the Treasury unless the Government obtained from Parliament full powers to enforce unpopular cuts.

During the spring of 1935 it became increasingly evident that the Treasury was struggling with acute difficulties. For a long time its cash resources were barely sufficient to meet requirements during the next few days. The attitude taken up by the Bank of France was well known and the public was sceptical as to whether Parliament would ever consent to delegate its authority to M. Flandin for the purpose of continuing the deflationary policy of his predecessor. Nor was M. Flandin himself keen to reverse his reflationary policy and embark once more upon a policy of deflation which he fully expected to fail. There appeared, however, to be no alternative, for it was essential that the solvency of the Treasury should be maintained. In the light of subsequent experience it may well be asked why M. Flandin did not decide to call the bluff of the Bank of France. Clearly it was not to the interest of the "200 Families" that the Treasury should default. After all, they were the principal creditors of the Treasury. Had M. Flandin intimated to them that unless they were prepared to grant the advances required by the Treasury the interest payment on the public debt would be suspended, they would in all probability have waived all their resistance and would have unconditionally supported the Treasury. Instead of doing this, M. Flandin agreed to attempt to obtain from Parliament the powers for deflation as ordered by the Bank of France. He submitted to the dictation of the "200 Families."

(6) The Panic of May 1935

It was suggested in the French Press that in order to make sure that Parliament would be willing to grant the powers, the French *haute finance* engineered in May an attack on the franc so as to intimidate public opinion and the politicians into agreeing to economy measures. There is no evidence in support of this theory, but even if it were ruled out there remains enough evidence to establish the fact that the Regents of the Bank of France were to blame for the crisis of May and June 1935.

During the first week of May, M. Flandin, completely cowed

by the financial powers which five months earlier he had hoped to break, submitted to Parliament a bill asking for full powers to tackle the budgetary position. It was pathetic to see this able and well-meaning statesman having to use his full powers of oratory to defend a policy he evidently did not believe in. All the time the debate was raging there was a heavy drain on the franc, and the Bank of France's gold losses reached record figures. There was a widespread feeling that should the Government be defeated, the experience of Belgium, where the Cabinet crisis led to the depreciation and subsequent devaluation of the currency, would be repeated. The atmosphere was panicky, and it appeared for a while as though the crisis of the franc might frighten Parliament into passing M. Flandin's bill. Eventually, however, the Government was defeated. Even though M. Flandin was prepared to submit to the dictation of the Bank of France, the Chamber, with its Radical majority, was not prepared to yield its authority to the executive on the demand of an extra-Parliamentary body. At least, it was not prepared to do so at that stage.

(7) The "Man of Destiny"

The resignation of the Government accentuated the panic and the heavy gold withdrawals continued. In order to avoid the Cabinet crisis being unduly prolonged, a neutral Government was formed under the Premiership of M. Bouisson, the Speaker of the Chamber. He chose for his Finance Minister M. Joseph Caillaux, in the hope that his reputation as a financial expert and his following among the Radical Socialists would go a long way towards securing the required majority in both Houses of Parliament. The new Government made an attempt to induce the Chamber to grant it the power which was refused to M. Flandin. It hoped that the aggravation of the financial crisis and the growing menace of street disturbances would induce the parties to agree to support the Bouisson-Caillaux Government.

There can be no question that M. Caillaux was the outstanding personality of this Government, and that its success in Parliament was to stand or fall upon the attitude of the Chamber towards him. M. Caillaux was regarded during the post-war chaos as the outstanding financial genius of France, who alone was believed capable of saving the country. During the period of 1924–6 he was in fact given the opportunity to show what he could do. The result was disappointing. In all fairness, allowances ought to be made for the political

deadlock caused by the conflict between the Chamber and the Senate, and the intrigues of his political opponents. Even so, M. Caillaux, while in office during that period, certainly did not show signs of being able to work miracles. The measures he adopted did not in any way confirm the high degree of optimism attached to his advent. In 1926 he had to resign, and, having failed to save the franc, he had to watch helplessly while his great enemy M. Poincaré saved it—an experience which would embitter many a statesman.

M. Caillaux was convinced that his failure was due to the intrigues and speculative attacks organised by his powerful enemies, and especially to M. Horace Finaly, head of the Banque de Paris et des Pays Bas. Indeed, he declared that his great mistake on assuming power was in not having arrested M. Finaly at once. After he was supplanted by M. Poincaré he confined his activities to rather unconvincing criticisms of the latter's policy, and was hoping against hope that he would be called upon once more to show what he could do. Time was against him, but he hoped that before he reached the "age limit" he would be given one more chance, if only in order to get even with his enemies.

(8) Exit M. Caillaux

His appointment as Finance Minister in the Bouisson Government appeared to have given him his great chance. Indeed, during the few days of his Government he appeared to have become completely rejuvenated. He was in high spirits, and his hopes were running high. The story goes that, on the morning of the fateful debate in the Chamber, on June 4, he said to a friend of his: "*Ce soir, la vote de confiance. Demain matin, les décrets. Et demain soir—la perquisition chez Finaly!*"

An uncharitable fate deprived him, however, of the opportunity he had lived for. There was some skilful lobbying done by those who knew what awaited them if M. Caillaux was confirmed in his office. It is possible, and even probable, that it was this lobbying that turned a sufficient number of votes against the Government to result in a minority of 2 at the fateful vote. M. Bouisson shared the fate of M. Flandin; the Chamber refused once more to yield to the Bank of France; and M. Caillaux returned to the wilderness.

After this second Cabinet crisis within a week, the political situation appeared really desperate. It seemed as though it was entirely impossible to form a Government which would

command a majority in the Chamber. The public was becoming exasperated with its politicians, and symptoms of street disturbances and acts of violence grew in number and intensity. It was feared that the events of February 1934 would be repeated. The menace of the Fascist *coup d'état* induced the leaders of the Parties of the Left to revise their attitude. Rather than expose themselves to that risk they were at last prepared to accept dictation from the Bank of France. M. Laval formed his Government and gained the vote of confidence from Parliament.

CHAPTER VIII

ENTER M. LAVAL

(1) The Hand of Nemesis

Fate willed it that from the political turmoil that followed M. Flandin's resignation, M. Laval should emerge as Premier of France. If the vindictive hand of Nemesis wanted to punish the French nation for the criminal short-sightedness of its politicians at Versailles and throughout the post-war period, it could not have chosen a better means to that end than to put M. Laval in charge of France during that critical period. The rôle he played during the summer of 1935 provided the turning-point in post-war history. His reckless deflationary efforts were largely responsible for the internal weakening of the Republic which, from its impregnable position of hegemony over Europe, declined practically into a *quantité négligeable* in foreign policy during a highly critical period, giving Hitler's Germany every chance of capturing the lead.

Before giving an account of his deeds during this fateful period, let us cast a glance over M. Laval's past record. The debit side of his political balance sheet was heavy long before he assumed office in June 1935. Those of my readers who happen to have read my books, *Behind the Scenes of International Finance*, *Finance and Politics* and *Montagu Norman—A Study in Financial Statesmanship*, are acquainted with the rôle M. Laval played during the crisis of 1931–2.

It will be remembered that when the Creditanstalt crisis threatened to develop into a world calamity, and while everybody was trying to do his utmost to prevent disaster, M. Laval's sole thought was to turn the financial crisis to the political advantage of France. By threatening to withdraw in the eleventh hour from the international salvage action, he attempted to force Austria to renounce her scheme of a customs union with Germany even before The Hague Court pronounced about the legality of that scheme. By this skilful manœuvre of political pressure he hoped to be able to force a crisis-ridden country on the verge of collapse to sell its birthright for a mess of pottage. His scheme failed through the swift inter-

vention of Mr. Montagu Norman, who unconditionally provided the support which M. Laval tried to sell at an exorbitant political price. The disturbing atmosphere created by M. Laval's aggressive action produced, however, a fatal effect upon the international financial situation. Before long the Austrian crisis developed into a Central European crisis, a European crisis, and a world crisis.

(2) M. Laval and the Crisis of 1931

Next on the list of indictments against M. Laval is the rôle he played in connection with the Hoover moratorium. For the first time since the Armistice, in June 1931, the United States Administration declared itself prepared to relax towards its European debtors. President Hoover's proposal for a one-year moratorium in war debts and reparations was of immense significance, and had it met with the response it deserved it might have created an atmosphere of optimism sufficient to call a halt in the progress of the financial crisis. But it was the misfortune of the world that M. Laval's consent was necessary for the adoption of the scheme. M. Laval had in himself all the narrow stubbornness that is the worst fault of his race—stubbornness which is often referred to as the " logic of the latin genius ". Even more than M. Poincaré, he deserved the nickname of " Monsieur Non-Non ". His response to Mr. Hoover's magnanimous gesture was petty haggling for fictitious advantages. The moratorium scheme was eventually adopted, but not before negotiations had threatened to reach deadlock several times. The suspense was more than the world's nerves could stand, and by the time the scheme was passed the panic had advanced too far to be checked. The result was the German collapse of 1931 and the subsequent flight from the pound.

During the sterling crisis of August and September, M. Laval realised that he had overplayed his hand and was prepared to assist Great Britain—at a price. Paris was willing to lend London, jointly with New York, anything up to the amount of the gold reserve of the Bank of England, and even beyond that amount, in return for political and commercial concessions. Rather than sacrifice her independence, Great Britain suspended the gold standard.

Following upon this, M. Laval tried to play the same game with the United States. Amidst the panic that followed the suspension of the gold standard in Great Britain, he hoped to be able to dictate his terms to Washington, thanks to the

weapon he held in the form of huge French official dollar balances. Mr. Hoover, however, refused to yield, and the subsequent wholesale withdrawal of French dollar balances was largely responsible for the undermining of confidence in the United States which led to the banking crisis of 1933 and the subsequent suspension of the gold standard.

(3) Postponement of the Lausanne Conference

Following upon his disastrous Washington visit, M. Laval focussed his attention upon retaining his hold on Germany by resisting any solution of the problem of reparations. It was evident that amidst the prevailing conditions Germany would not be in a position to resume reparations payments for many years. Indeed, it was obvious that any attempt to compel her to do so would only strengthen the hands of extreme Nationalists, and that no German Government would assume responsibility for agreeing to the resumption of payments.

For all practical purposes, reparations were dead. Unfortunately they were not buried. It was the task of the coming Lausanne Conference to arrange for their funeral. The Conference was to take place in January 1932, but M. Laval decided otherwise. He insisted upon the postponement of the Conference until June, partly because he wanted it to take place after the General Election in France and partly because he hoped that in the meantime the British attitude might change in his favour. His judgment proved to be hopelessly wrong in both respects. The French electorate, by returning a Radical-Socialist Government, pronounced itself against the negative policy pursued by M. Laval regarding reparations, and the British Government remained strongly in favour of a conciliatory policy.

At Lausanne in June 1932 reparations were virtually abolished, even though a reduced amount was retained to save the face of the French Government. It was obvious even in January that some such solution would have to be agreed upon. Had it been adopted in January, world history might have taken a different course. It was the postponement of the Lausanne Conference that led to the downfall of the Brüning Government in Germany, a downfall which prepared the way for the advent of Hitler eight months later. Had M. Laval agreed to what his successor accepted at Lausanne, it would have strengthened Dr. Brüning's position, and the National-Socialist party, which had already entered the phase of decline, would never have assumed power. M. Laval,

through his stubborn refusal to face realities, was as much responsible for the advent of Hitler, with all that this implied, as any human being. We shall see later that, having brought in Hitler through his stubborn refusal to yield in the matter of reparations in 1932, he secured Hitler's supremacy through the stubborn deflationary policy he adopted in 1935.

(4) The Abyssinian Game

The General Election of April 1932 removed M. Laval from the Government, but unfortunately not for long. In 1934 he was back as Minister of Foreign Affairs. Although the rôle he then played was purely political, his character-sketch would not be complete without referring to it briefly. He paid a visit to Signor Mussolini in January 1935 in order to settle the differences between France and Italy. The object was highly laudable, but the way M. Laval attained it carried the seeds of disaster for Europe and not least for France itself. Faithful to himself, M. Laval sought to secure Signor Mussolini's friendship at the lowest possible cost to France. Having realised that it was necessary to satisfy Italy's colonial ambitions, he was prepared to relinquish in Italy's favour a worthless slice of the Sahara, and since this was obviously not enough, he gave Signor Mussolini a free hand to help himself to Abyssinia. A block of the Djibouti–Addis Ababa railway shares passed from the French Government to the Italian Government. M. Laval indicated his *désintéressement* in Abyssinia.

What followed is too well known to require recapitulation. How M. Laval, embarrassed by the British attitude towards the Italo–Abyssinian conflict, tried to run with the hare and hunt with the hounds throughout the negotiations that preceded the invasion of Abyssinia, and also during the period of sanctions, is a matter of general knowledge. What is not known by the uninitiated public is the rôle he played in connection with the negotiations that led to the ill-fated Hoare–Laval agreement. That agreement, which was subsequently represented as having been suddenly arrived at during Sir Samuel Hoare's brief Paris visit, was in fact negotiated weeks before Sir Samuel's journey by the permanent officials of the British and French Foreign Offices and by Signor Enzio Garibaldi, Signor Mussolini's unofficial emissary, who paid a visit to London and Paris in November 1935. While some modifications of detail may have been agreed upon during the direct negotiations between Sir Samuel Hoare and M. Laval, the broad principles

were already fixed in advance and were accepted by Signor Mussolini.

There was only one snag which prevented the conclusion of an agreement which might have saved the independence of at least part of Abyssinia, and which would have paved the way for friendly relations between Italy on the one hand and France and Great Britain on the other. This was M. Laval's claim upon the Harar district, which, he insisted, belonged to the French sphere of interest. Having bought Italy's goodwill in January by giving Signor Mussolini a free hand in Abyssinia, and having failed to keep his bargain by joining, however half-heartedly, in the economic sanctions imposed by the League, M. Laval now wanted to get his purchase price back. He was quite willing to agree to the partition of Abyssinia, keeping a slice for France, League or no League. Naturally enough, his greed caused indignation in Rome, and Signor Mussolini was not prepared to accept his claim. Haggling over this point was responsible for the delay which provided an opportunity for the leakage of information that led to the premature disclosure of the agreement. It was the indignation caused by M. Laval's game that was largely responsible for Signor Mussolini's outburst at Pontinia which aroused public opinion in Great Britain and elsewhere against the Hoare–Laval agreement. That agreement was ignominiously rejected, Abyssinia was conquered, and Signor Mussolini was driven into Hitler's arms.

(5) Short-sighted Policy

I must apologise to my readers for this digression into the sphere of politics, but in order to understand the suicidal policy pursued by France during the late summer and autumn of 1935 it is necessary to gain an insight into the character and past record of the man responsible for it. The facts enumerated above reveal M. Laval as a stubborn and short-sighted politician who was concerned only with apparent and immediate results for France, and who for their sake was always prepared to risk and sacrifice vital interests. He was naturally incapable of taking a long view, and his judgment was utterly unreliable. He was in his element when he could take up an aggressive line, whether against crisis-ridden Austria or Dr. Brüning's well-meaning Germany, his former allies or his own nation.

All these characteristics manifested themselves only too clearly in the reckless deflationary policy on which he embarked in July 1935. For the sake of bringing immediate relief to

the franc, he cheerfully embarked on measures which were evidently bound to aggravate the fundamental position in the long run. He hopelessly misjudged the French nation in believing that it would be willing to put up with the unnecessary sacrifice inflicted upon it by his deflationary drive. The aggressive spirit in which he dealt with opposition to his policy bore its fruit a year later in an equally aggressive spirit on the part of the classes which he oppressed at the point of the bayonet. As in 1931–2, so in 1935–6, he completely misjudged the French electorate, which on both occasions rejected the policy for which M. Laval stood.

CHAPTER IX

DEFLATION WITH MACHINE GUNS

(1) Hopeless Budgetary Position

When early in June 1935 M. Laval's Government received the vote of confidence of the Chamber and obtained powers to deal with the financial situation by decree, everybody wondered how he would set about his task. Many people believed that M. Laval would follow the example of his predecessors by attempting to balance the budget on paper, leaving it to his successor to cope with the discrepancy that inevitably arises between estimates and actual receipts and expenditure. This had been done time after time since 1932, and each time the announcement of a balanced budget restored confidence in the franc for the moment, until it became evident that the budgetary equilibrium was purely fictitious. For anyone who was acquainted with the facts and figures of the French situation it was obvious that there could be absolutely no question of balancing the budget on the basis of the existing value of the franc.

The extent to which expenditure was capable of being reduced was limited by the existence of a dead-weight debt of some 350 milliard francs. There was no hope of reducing the interest burden by conversion amidst the prevailing conditions of distrust and monetary stringency. The remaining expenditure items had already been reduced by M. Doumergue to such an extent as to make it difficult to find any further substantial economies. Indeed, even the expenditure on national defence was subject to economies, at any rate in a negative sense, at a time when the arch-enemy was spending milliards on rearmament. The Civil Service was seething with discontent owing to the cuts in their salaries made in 1934 and was not in a mood to submit to new cuts. Nor were ex-Service men willing to agree to any reduction of their pensions.

The outlook for increasing revenue was, if anything, more hopeless. Trade was depressed and could not possibly stand the burden of additional taxation. The old war-cry of suppressing fiscal evasion could, of course, be raised once more,

but to anyone acquainted with French conditions it must have been evident that a new attempt to that end would not meet with any more success than all the previous attempts.

(2) Futile Deflation

Moreover, deflation in France had reached a stage by 1935 beyond which it could not possibly proceed without provoking reflationary influences. It was impossible to lower the prices of land products owing to the political power of the agricultural population. In any case, the curtailment of the purchasing power of the agricultural classes would inevitably have resulted in all-round aggravation of the depression and a fall in revenue. Even if it had been possible to reduce further salaries, wages, prices and the cost of living, it would only have meant a further aggravation of the burden of public and private indebtedness. Evidently France was in a blind alley, and the only way out led through devaluation.

M. Laval, with his customary short-sightedness, was not prepared to recognise this. He was quite willing to play the game of the Bank of France by forcing sacrifices upon the nation in order to postpone the inevitable. Nor was he satisfied to follow the method of his predecessors who concentrated all their efforts upon reducing expenditure on the supply services. He wanted to do better by adopting the method of "consistent deflation". This method was first applied by Signor Mussolini, who on two occasions enforced an all-round cut in wages, salaries, prices, rents, hotel charges, etc. He was in a position to do so, owing to his dictatorial powers and owing to the discipline of the Fascist economic system. All the classes concerned put up with the cuts without a murmur, or at any rate without loud enough murmurs to be audible at the Palazzo Venezia. M. Laval did not realise that what could be done in a totalitarian state could not be done in a democratic state. He had no power to compel industrial workmen to accept cuts, or to enforce an all-round reduction of commodity prices. Such a thing is impossible in a democratic country in time of peace. It was a gross error of judgment on M. Laval's part to attempt this impossible task.

(3) M. Laval's Decrees

For some weeks after Parliament had granted him the necessary powers, nothing happened. It was said that the elaboration of the measures M. Laval intended to take required time. In fact he was marking time in order to get past the

fateful date of July 14, when Paris is usually the scene of street demonstrations. He was afraid that his deflationary measures might accentuate those demonstrations into grave riots, and preferred to wait with his measures, especially as, with the advancing summer holidays, Paris would become emptier and the likelihood of riots would diminish. Once the Paris streets had calmed down sufficiently to reduce the momentary danger of disturbances to a minimum, M. Laval came out on July 16 with a staggering batch of decrees. This was followed by further batches, aiming at making the deflationary drive as widespread as possible. The wages and salaries of Civil Servants were reduced by a further 10 per cent, though the cut for wages and salaries under 10,000 francs was more moderate. In order to disarm resistance to these cuts, an effort was made to lower the cost of living by decree. To that end, the prices of essentials such as bread and other foodstuffs, coal, charges for gas and electricity, and rents, were reduced. In order to pacify the agricultural population, the price of fertilisers and interest on mortgages was reduced. Debtors were released from their contracts provided that they were able to repay their loans before maturity by borrowing at a lower rate elsewhere.

It was without precedent in liberal France that in time of peace the Government should interfere with the terms of private contracts by enforcing a cut in rents, interest on mortgages, etc. Above all, it was without precedent since the great Revolution that the Government should default on its own obligations by reducing the interest on its loans fixed by contract. This is what M. Laval had actually done. In this respect he went even further than Signor Mussolini. The latter, while carrying out what amounted in practice to a forced conversion—dissenters had to fill in their application for repayment on three forms: one for the local authorities, one for headquarters, and one for the local organisation of the Fascist party!—was at pains to keep up appearances, and the transaction was represented as a "voluntary" sacrifice on the part of bondholders. The system adopted by M. Laval was much cruder. He simply reduced by decree the interest on all Government loans by 10 per cent. This was an act of repudiation pure and simple.

The absurdity of M. Laval's attitude in this respect is past understanding. He came to office as the supreme defender of the franc, which was represented as a symbol of the French commercial integrity. He refused to devalue on the ground

that it would have been regarded as an act of default, and in order to avoid having to commit this act of default he committed another act of default much more iniquitous than any reasonable devaluation could possibly be. He told the French rentiers that he was fighting their battle, that it was in order to safeguard their interests that he was defending the franc at the cost of heavy sacrifices. In the same breath he inflicted a cut upon the income of rentiers by breaking the agreement concluded with them. Even if at the cost of this default it had been possible to save the franc, the result would not have been worth the sacrifice, from the point of view of the rentiers. As it was, the rentiers were victimised both ways, for in spite of the reduction of their interest the purchasing power of their incomes was also subsequently reduced through the rise in the cost of living that took place before and after devaluation.

(4) The Consequences of M. Laval's Measures

Considering the drastic nature of M. Laval's measures, the extent of political resistance to them was remarkably small. Parliament was adjourned until late in the autumn so that disapproval of the measures could not manifest itself in a constitutional way. Nor did they lead to as much resistance in the country as was expected. There were, it is true, a number of strikes and violent protests, but there was no indication of any recurrence of the events of February 1934, and M. Laval had his own way of dealing with the resisters. In the naval dockyards of Brest and Toulon the strikers were kept at bay with the aid of machine guns. While in February the Radical Government of M. Daladier had been informed by the military commanders that the Army was not to be used for the political purpose of resisting the riots that threatened to overthrow Government and régime, the Conservative Government of M. Laval had at its free disposal the full power of the armed forces to deal with the manifestation of any discontent over its deflationary policy.

Is it surprising that, when in the following year the executive power passed from Conservatives to Socialists, the working classes should take undue advantage of this? Under M. Laval the dice were loaded against them. Under M. Blum they were loaded in their favour. Human nature being what it is, it was inevitable that the workers should use and abuse the advantage they acquired through the result of the General Election for the purpose of extorting by violent means an improvement of the terms of their employment. The stay-in

strikes of 1936 were the direct reply and the logical consequence of M. Laval's machine-gun deflation of 1935.

After a certain amount of resistance and protest, France accepted M. Laval's decrees. His sole concern was to attain his immediate object, and in this respect he had every reason to be satisfied with the result of his effort. From a narrow and short-sighted point of view M. Laval scored a great triumph. It is true that the success of adopting unprecedented deflationary measures made no difference to the fate of the franc in the long run ; that it was unable to produce a decline of prices or cost of living, or even to arrest their rising trend ; that it paved the way for the victory of M. Laval's opponents in the General Election. But it would have been too much to expect M. Laval to foresee this, even though it must have been evident to all clear-thinking people. The immediate result was all he cared about, and that, at any rate, appeared to be satisfactory. The technical position of the franc improved somewhat. The outflow of capital ceased and there was even a reflux, enabling the Bank of France to recover part of the gold it had lost during the crisis of May and June. In the absence of any acute attack on the franc it was possible to lower the bank rate, even though conditions in the money market remained invariably stringent. The Bank of France, satisfied with M. Laval's deflationary effort, was willing to continue financing the Treasury's deficit. All was well for the moment, and to think ahead about the ultimate consequence was beyond M. Laval's statesmanship.

CHAPTER X

DR. COLIJN'S REMEDY

(1) Recovery of the Guilder

We have seen in Chapter V that the attack on the guilder ceased when the attention of speculators became focussed upon the Swiss franc. Subsequently the storm-centre shifted from Zurich to Paris. With the adoption of M. Laval's drastic deflationary measures, the franc ceased to provide for the moment any scope for speculative activity. The attention of international speculators turned once more towards the guilder. There is no smoke without fire, and the speculative attacks of July and September 1935 would never have occurred had it not been for the political crises experienced in Holland at the time. These crises were, however, the direct outcome of Dr. Colijn's policy, and as such deserve our attention as examples of the political effect of deflationary dogmatism.

By May 1935 most people realised that the Dutch authorities were determined to continue the defence of the guilder and that technically they were in a position to do so for a long time to come. Thus the flight of Dutch capital became reversed and the speculative positions were largely liquidated. In particular after the termination of the franc crisis pessimism regarding the prospects of the guilder abated. It had always been taken for granted by most people that the guilder could not possibly survive the devaluation of the franc, and the removal of the likelihood of such a change was naturally a bull point for the Dutch currency. The atmosphere in June and early in July was calm and, taking a short view, confident. There was no panic, and there was no need for panic measures.

(2) No Need for Drastic Measures

Nor did the fundamental position call for any drastic steps. The situation of Holland was different from that of France. Admittedly the difference was largely one of degree. The same phenomena which made resistance to devaluation in France appear in the long run hopeless existed also in Holland, but on a much smaller scale. It was no more possible to

balance the Dutch budget on the basis of the existing value of the currency than it was possible to balance the French budget without devaluation. The Dutch deficit was, however, relatively moderate and manageable. Although the Dutch public debt was large for the size of the country, it was very far from being unbearable. While the French Government found it increasingly difficult to cover its deficit by borrowing from the public, and the terms of its new loans were becoming increasingly unfavourable, the Dutch Government was able to borrow easily and at a relatively low interest rate.

While in France the budgetary deficit forced the Government to resort to inflation through borrowing from the Central Bank, in Holland it would have been possible to cover the relatively moderate deficit by means of normal borrowing for many years without thereby raising the burden of the public debt to a prohibitive level. In brief, even from the point of view of the defence of the currency there was no need in Holland for " heroic " measures similar to those resorted to in France in totally different conditions. Nor did the foreign trade position call for any desperate measures, especially as the colonies covered much of the import requirements of the motherland.

(3) " Heroic " Effort

In the circumstances it may well be asked why Dr. Colijn attempted to force upon the Dutch Parliament in July 1935 deflationary measures which in some ways would have overshadowed even M. Laval's staggering deflationary drive. Drastic as the proposed measures were, they would not have been able to correct the international disequilibrium of the guilder. The only acceptable explanation is of a personal nature. In Chapter V I recalled the rôle played by Dr. Colijn in establishing the Gold Bloc at the Economic Conference of 1933. He must have felt that as the creator of the Gold Bloc he was bound to be second to none in the defence of his national currency. He must have considered it a matter of prestige to show that he could do as well as M. Laval in defending the currency at the cost of national sacrifice. Hence his display of " heroics ", which was not called for by the Dutch situation, and which proved to be a boomerang in that it led to a crisis of the guilder.

In July 1935 Dr. Colijn introduced legislation for the adoption of a series of measures of " consistent deflation " somewhat similar to those enforced by decree in France. The

Dutch Parliament was not prepared, however, to pass these measures. Dr. Colijn threatened to resign unless they were passed, but in spite of this some of the members of the parties on which the Government majority was based refused to support him. He and his adherents, in order to frighten Parliament into submission, pictured the consequences of the rejection of the bill in the gloomiest possible colours. They were at pains to convince Parliament that the fate of the guilder depended upon the acceptance or rejection of the bill. Whether or not Parliament took their word for it, the bill was *not* passed, and Dr. Colijn resigned on July 25.

(4) Dr. Colijn Yields

There followed a few days of difficult negotiations in an attempt to form an alternative Government. Several of the party leaders, who were requested by the Queen to undertake this task, had to abandon the attempt. Meanwhile there was a renewed flight from the guilder and a speculative attack. Once more the Netherlands Bank was losing gold on a large scale. Between July 8 and 29, the gold reserve declined from 681 million guilders to 558 million guilders. The bank rate was raised to 6 per cent. Apart from the fact of the political crisis, pessimism towards the currency was largely due to Dr. Colijn's gloomy forecast of what would happen to the guilder if the bill was rejected.

The crisis was ended by the return of the Colijn Government in a reconstructed form. The run on the guilder subsided, but not for long. Once more, in September, Dr. Colijn attempted to force his measures, in a somewhat modified form, upon Parliament. Once more Parliament was not prepared to pass them, and in September this conflict once more created the atmosphere of a crisis leading to a renewed run on the guilder. The Netherlands Bank lost another 55 million guilders of gold, and it had to raise its rediscount rate once more to 6 per cent. It appeared as though Dr. Colijn was too stubborn to accept a compromise, and since it was impossible to find an alternative Government with a working majority, the deadlock appeared to be complete. Fortunately for Holland, in the eleventh hour the statesman-like qualities of Dr. Colijn got the better of his stubbornness. Having realised that he could not have his way, he was eventually willing to compromise by adopting half-measures which reduced the deficit without eliminating it. His other deflationary measures were also severely curtailed before being adopted.

Once the political crisis was over the crisis of the guilder also came to an end. Even though in July Dr. Colijn claimed that the full adoption of his measures was indispensable for saving the guilder, in September the adoption of half-measures proved to be sufficient to restore confidence. From that time onward until the devaluation of the franc twelve months later, the guilder was exposed to hardly any abnormal pressure on a large scale. The Central Bank recovered some of its gold. Jobbing backward, we may well ask why it was necessary to put the country through all the unnecessary excitement of July and September 1935. Those crises, which might have developed into something much worse, might easily have been avoided but for the doctrinairism of Dr. Colijn, by which he regarded it as a matter of prestige to outbid any country in the civic virtues of deflation.

CHAPTER XI

THE SWISS BANKING CRISIS

(1) Withdrawals of Deposits

The result of the referendum of June 2, 1935, relieved the pressure on the Swiss franc. A respite from the selling pressure was indeed badly needed, for during the second quarter of the year the Swiss National Bank lost gold to the amount of 530 million Swiss francs. This in itself was no major disaster, for even after these heavy losses the Swiss National Bank's reserve ratio remained very high. The reason why the flight from the Swiss franc gave rise to concern was that it involved wholesale withdrawals of deposits from the Swiss banks. The total deposits of the seven leading commercial banks declined during the first half of 1935 from 3,358 million francs to 2,793 million francs. Even this in itself should not have given rise to uneasiness but for the fact that the withdrawals were met to a very large degree out of the cash resources of the banks instead of by liquidating other assets. During the first half of 1935 the cash assets of the seven leading banks declined from 689 million francs to 319 million francs, a decline of 370 million francs or rather more than half the total cash resources.

It is easy to explain the reluctance of Swiss banks to meet withdrawals by calling in loans. A large proportion of loans granted to Swiss customers became frozen owing to the prolonged depression. Only the very best of their customers would have been able to repay their advances, and naturally enough the banks were not at all keen on losing their first-class business. In any case, had the banks embarked upon calling in credits on a large scale they would inevitably have aggravated the economic depression. The alternative course was to liquidate at a heavy loss their standstill credits in Germany. The amount of those credits was exceptionally large. While French, Italian, American and Dutch banks had considerably reduced their commitments between 1931 and 1935, Swiss banks were reluctant to cut their losses. Meanwhile the depreciation of blocked marks made it increasingly costly to liquidate standstill commitments.

(2) Excessive Standstill Commitments

At the beginning of 1935 the commitments of Swiss banks in Germany and other countries subject to transfer restrictions were still abnormally high. In the case of three of the " Big Seven " it amounted to about one-third of their balance-sheet total. This fact was in itself apt to inspire distrust in the solvency of various banks, especially since the withdrawal of their deposits further increased the relative importance of these frozen foreign assets. It was apt to inspire distrust in the Swiss banking system as a whole, and in the Swiss franc. Indeed, according to one theory, the distrust in the Swiss franc was largely the consequence and not the cause of the distrust in some of the leading banks. However it may be, the fact is that, as a result of the heavy losses of deposits during the second quarter of 1935, depositors began to view the position and prospects of their banks with growing concern.

While some of the banks realised the necessity of making an effort to keep up their cash reserve in face of the withdrawals of deposits, others simply allowed their cash supplies to be depleted before they made up their minds to make the necessary sacrifice by liquidating their German standstill credits at a loss. As a result there was a scramble to sell out registered marks during the second half of 1935, and the discount on registered marks against free reichsmarks widened considerably. This depreciation resulted in complete deadlock in the case of several banks. In order to liquidate an adequate proportion of their standstill credits they would have had to cut a loss of an amount in excess of their total capital and reserves. The position was, therefore, that they could not afford to keep their excessive German credits and they could not afford to liquidate them.

(3) Bank Suspensions

While they were marking time, the uneasiness of the public was growing incessantly. The debenture bonds issued by the banks were not renewed and time deposits were also being withdrawn on maturity. These movements continued even after the flight from the Swiss franc came to an end. During the third quarter of 1935 the total time deposits of the seven big banks declined by 50 million francs, and the total debenture bonds by 40 million francs.

The adverse pressure proved to be too much for a number of Swiss banks, big and small. Among the leading banks the

Banque Commerciale de Bâle and Leu et Co., Zurich, had to apply for a moratorium. Other banks were also very much talked about, and a stage was reached when only one or two commercial banks were considered to be above suspicion. It appeared at times as though a first-rate banking crisis similar to those witnessed in the United States in 1933 and in Belgium in 1935 would be inevitable.

The obvious defence against such a menace would have been the devaluation of the Swiss franc. Just as it was capable of stopping an acute banking crisis in the United States and in Belgium, it would have been capable of reversing the menacing trend in Swiss banking. The Government would have been in a position to change the trend with a stroke of the pen but refused to do so. Rather than devalue the franc it exposed the country to the possibility of a wholesale inflation through the necessity of official support of the banks that might easily have become inevitable.

(4) Cessation of Withdrawals

Fortunately for the Swiss banks and for Switzerland as a whole, the deterioration of the banking position did not continue after the end of 1935. The withdrawal of foreign balances ceased, because most of the balances which were still left belonged to nationals of countries with exchange restrictions who were not in a position to transfer their funds to some other centre without running the risk of being caught out by their own authorities. Apart from this, at the cost of heavy sacrifices most banks reduced their German commitments to a large degree, thereby improving their cash position. Drastic reconstructions were carried out which, without remedying the position, went some way towards clarifying it.

The fundamental situation remained, however, unchanged, and the Swiss banking system remained highly vulnerable. Had a wholesale flight of capital been resumed, it would have dealt a fatal blow to the banking structure, and there was no reason to suppose that after June 1935 Switzerland was safe from a revival of the run on the franc. Apart from any inherent cause of weakness, the collapse of the French franc would inevitably have led to a flight from the Swiss franc. Strangely enough, even though everybody in Switzerland realised that France was fighting a losing battle, a large number of people holding official positions maintained that Switzerland would continue to resist even after a collapse of the French franc.

(5) Effect of Overvaluation of Currency on Banks

The experience of Switzerland during 1935 provides a characteristic example of the destructive effect of the overvaluation of a currency upon the banking situation. Admittedly the Swiss banking system was not without weak spots. The number of banks, big and small, was excessive for a country of Switzerland's size, and this in itself, together with the political decentralisation of the country, made it difficult for the authorities to intervene in support of banks in difficulties. While in other countries moratorium was averted by timely support, in Switzerland two of the leading banks and a large number of smaller banks had to be brought under moratorium, even though, in some instances at any rate, the banks were well worth rescuing. Admittedly most banks were guilty of overlending to Germany, but this in itself would not have got them into trouble had it not been for the difficult internal situation caused by the stubborn defence of the franc at an overvalued level.

In Switzerland the international functions of banks constituted an important item in the national income. It was all the more remarkable that the Swiss authorities and the banks themselves were fully prepared to jeopardise the goodwill of the banking system by allowing some of their leading banks to come under moratorium. Even though foreign creditors were treated with discrimination, such developments could not help creating a bad impression abroad. On the basis of the experience of London, whose position as an international banking centre did not suffer through the depreciation of sterling, the Swiss authorities ought to have known that if the choice lay between two evils the devaluation of the franc was the lesser. But then, as they were prepared to sacrifice, for the sake of the defence of the franc, the prosperity of the country's extensive trade based on tourist traffic, it is not surprising that they were prepared to jeopardise also the country's international banking position.

Now that the Swiss franc has had to be devalued after all, in spite of all efforts, there is hardly anyone in Switzerland who would say that it was worth while prolonging the futile defence at the cost of such sacrifices. The question is, has Swiss opinion learnt this lesson for future reference? Has the Swiss public realised adequately that in face of an adverse pressure due to substantial disequilibrium, resistance to devaluation is bound to collapse in the long run? Has it realised that even

in case of successful prolonged defence the result is hardly worth the sacrifice? If so, the banking crisis of 1935 was, in spite of the losses it inflicted upon a large section of the public, a blessing in disguise.

CHAPTER XII

DEVALUATION IN DANZIG

(1) Overvaluation of the Gulden

Hitherto we have been concerned with the fate of the leading gold currencies. The importance of each one of the three currencies of the Gold Bloc proper was sufficient to determine the fate of the whole Gold Bloc and its satellites. Devaluation by any of them would inevitably have resulted in the collapse of the resistance of the whole Gold Bloc. The main battles of the Gold Bloc were fought in Paris, Amsterdam and Zurich. In addition, however, secondary battles were fought in various directions. The success or failure of the defence of various currencies of second-rate or third-rate importance could not influence the general situation to any noteworthy extent. It was, however, not altogether unimportant from a psychological point of view. Let us therefore divert our attention for a moment from the main battlefield, to one of the " side-shows ".

The Danzig gulden constituted one of the satellites of the Gold Bloc. While two of the Baltic currencies, the Finnish mark and the Estonian krone, were devalued, the Free City of Danzig continued to defend its old parity. This was due to the political and commercial influence of both Germany and Poland, in face of which the financial influence of Great Britain was unable to prevail. And yet the Free City could ill afford to defend its currency at its overvalued level. The results of its efforts to that end were similar to those experienced in other countries with overvalued currencies. The anticipation of the inevitable devaluation resulted in an outflow of capital and hoarding. Consequently deposits with commercial banks and savings banks underwent a sharp decline.

(2) Loss of Deposits and Gold

Between the end of 1929 and the end of 1934, deposits with commercial banks fell from 154 million gulden to 88,500,000 gulden. Savings banks' deposits declined from 89 million gulden to 69 million gulden. The extent of the depression

is illustrated by the fact that the amount of bills discounted declined from 54,700,000 gulden to 18,600,000 gulden. There was a further sharp decline during the first four months of 1935, especially during April, when, following upon the devaluation of the belga, pessimism regarding the prospects of the gulden became accentuated.

It must be admitted that the difficult situation in Danzig was not due exclusively to the overvaluation of her currency. The increasing political influence of Germany in the administration of the Free City played an important part in bringing about the crisis of April–June 1935. For one thing, a large part of the proceeds of Danzig exports to Germany was allowed to become frozen, and the Government of the Free City, which was in fact, if not in law, a subordinate authority to the Government of the Reich, did not adequately press for the liquidation of these frozen claims. It is also suggested that there was collusion between the authorities of Danzig and those of the Reich to pass on to the possession of the latter part of the former's gold and foreign exchange stock, which in any case was subject to heavy pressure through the flight from the gulden. However this may be, the fact is that the gold and foreign exchange stock declined from nearly 40 million gulden to 26,500,000 gulden during 1934, and fell to 13,500,000 gulden by the end of April 1935. The reserve ratio declined well below the statutory amount of 40 per cent of sight liabilities. There were signs of a rising financial panic. Desperate efforts were made to obtain help in London, but with a negative result. In the circumstances there was no choice but to devalue.

(3) A Mismanaged Devaluation

In order to pacify Polish opposition to devaluation, it was decided that the gulden should be brought level with the Polish zloty by devaluing it by 42·37 per cent. Politically and commercially this may have been wise, but financially it was certainly a grave mistake. By adjusting the gulden to the zloty, the Danzig authorities failed to allay pessimism towards its prospects. Although the devaluation to an extent which was approximately equal to the devaluation of the dollar or the depreciation of sterling would have been sufficient to restore equilibrium, the fact that the currency was linked to the zloty created an unfortunate impression. The public was inclined to take it for granted that henceforth the gulden would share the fate of the zloty. The latter had

been struggling against devaluation, together with the other satellites of the Gold Bloc, at an overvalued level. It had been widely assumed that sooner or later the zloty would have to be devalued. And since the gulden was now linked to the zloty, the view was widely held that if the latter was devalued the gulden would also undergo a second devaluation. Throughout April and May there was a strong wave of distrust against the zloty and consequently there was a wave of distrust against the gulden, even at its lower level. The flight of capital continued unabated.

(4) The Panic of June 1935

Although the devaluation of the gulden on May 2, 1935, improved the technical position of the Bank of Danzig, it failed to allay the panic, which reached its climax at the beginning of June, when there was a run on the banks and savings banks. Apart from the fears of a second devaluation of the gulden, this run was to a large extent a consequence of the profound distrust of the public in the National Socialist administration, which, it was feared, was prepared to sacrifice the interests of the Free City to those of the Reich. In face of the run, it became necessary to declare a banking moratorium and to introduce exchange restrictions. The banking moratorium came to an end in July but the exchange restrictions remained in force.

The immediate effect of devaluation in Danzig was thus anything but satisfactory. Opponents of devaluation throughout the world took advantage of this and for months gave that experience a publicity that was entirely out of proportion to the relative importance of Danzig. Judging by the Press in the Gold Bloc countries, Danzig must have been many times more important than Belgium, since the space devoted to the favourable results of devaluation in Belgium was but a fraction of the space devoted to the unfavourable sequel to the devaluation of the Danzig gulden. It is true that the special circumstances to which the failure of devaluation in Danzig was attributed were only too glaringly obvious. This did not, however, prevent anti-devaluationists from glossing over the inconvenient facts and making full use of the Danzig experience for propaganda purposes.

(5) The Panic Subsides

In reality it is not correct to regard the panic of June as a consequence of the devaluation. Already at the end of

April signs of a panic were not lacking, and had the Free City not devalued the run would probably have reached its climax in May instead of June, at a time when the technical position of the Bank of Danzig itself was also highly unsatisfactory. The writing up of the gold and foreign exchange reserve as a result of the devaluation improved at least the technical position of the Central Bank and enabled it to face the subsequent panic.

Moreover, taking a long view, the result of the devaluation in Danzig, in spite of the grave mistake committed, was not nearly so unfavourable as it was made to appear under the effect of the panic in June. During July the panic subsided, and during the following two months the banks improved their position to a sufficient extent to liquidate a large part of the emergency support received from the Central Bank. The Bank of Danzig's bill portfolio declined from 26,300,000 gulden to 15,900,000 gulden during the second half of 1935. Its note circulation and other sight liabilities also contracted from 39,200,000 gulden on April 30 to 31,900,000 gulden on September 30, 1935. It became possible in July to relax exchange restrictions, and in October the Bank of Danzig lowered its rediscount rate from 6 to 5 per cent.

(6) Prices and Trade

The opponents of devaluation watched with satisfaction the rise in commodity prices that followed the devaluation of the gulden. The index number of wholesale prices advanced from 64·3 in April to 85·7 in May, and gradually advanced further, reaching its climax in November at 102·6. This rise was only partly the consequence of the actual devaluation; to a very large degree it was the result of the anticipation of a second devaluation, an anticipation which might have been avoided had the Free City not decided to link the gulden to the zloty. It was this act which was largely responsible for the panic-like buying of commodities throughout the months that followed devaluation. Towards the end of the year, however, when the public began to realise that a second devaluation was not imminent, the movement of prices became reversed, and by February 1936 the index number was down to 99·4. Even at that level the price level in Danzig was considerably above that of the Sterling Bloc or the United States. The gulden remained overvalued, notwithstanding its devaluation. As far as the cost of living was concerned, the rise was, however, much less spectacular. From 75·6 in April 1935, the

index number of the cost of living advanced to a maximum of 92·7 at the end of 1935, which is only slightly higher than the index for the United Kingdom, and about the same as the index for Sweden or Denmark.

As a result of the increase of purchases in anticipation of a second devaluation, trade in Danzig revived to some extent, and unemployment became halved towards the middle of 1936. While the unfavourable results following immediately upon devaluation received the widest possible publicity in the Press of the Gold Bloc, gradually when Danzig began to recover she disappeared from the limelight. According to a time-honoured saying, " No news is good news." From the point of view of anti-devaluationist propaganda, on the other hand, good news from Danzig was no news.

CHAPTER XIII

THE SECOND FRANC CRISIS

(1) Prospects of Political Troubles

We have seen in Chapter IX that M. Laval, acting upon the powers conferred upon him by Parliament to take measures for the defence of the franc during the summer recess, enforced a series of drastic deflationary measures, and that his ruthless deflation met with but little resistance in the country. The orthodox camp was triumphant. M. Laval's measures were quoted as conclusive proof that, after all, it was possible to defend an overvalued currency by means of deflation, if only there was sufficient determination to carry through that policy. M. Laval became the hero of the anti-devaluationist camp all over the world. His example was to inspire the timid Governments of other countries into vigorous action. Indeed, we have seen in Chapter X how it did inspire Dr. Colijn to follow his example in Holland.

Notwithstanding this, the French orthodox school was not altogether happy. Although M. Laval issued his decrees during the summer, he would have to face Parliament in the autumn, and several politicians upon whose support his majority depended had already indicated their determination to refuse to ratify some of the measures. There appeared to be every likelihood of a first-rate political crisis during November. It was hoped, however, that by that time deflation would have produced its beneficial effects, in face of which the Parliamentary parties would not dare to destroy the good work done by M. Laval.

(2) Inadequate Effects of Deflation

Another reason why the anti-devaluationist camp was not altogether happy was that M. Laval's heroic measures met with so little response among the public. According to the view held by the Bank of France, it was sufficient for the Government to show determination to tackle with a firm hand the budgetary deficit and the overvaluation of the franc to bring about a return of confidence manifesting itself in whole-

sale repatriation and dis-hoarding. In this respect the result of M. Laval's efforts was utterly disappointing. During May 1935 the Bank of France lost gold to the amount of 10 milliard francs. Between May and November it succeeded in recovering only something like 1½ milliard francs. Even this was mainly attributable to bear covering and repatriations by business men who had over-exported capital and had to bring back some of the funds for their current requirements. Needless to say, the orthodox camp had a good explanation for the absence of any wholesale repatriations and dis-hoarding. It would not have been safe to suggest so soon after the drastic cuts that additional cuts would be necessary to restore equilibrium. It was suggested, however, that since, pending the ratification of M. Laval's decrees, the effect of his deflationary measures was uncertain, confidence would not be restored until those measures had received the blessing of Parliament.

There were other reasons for deflationists to view the situation with growing concern as the autumn progressed. The deflationary decrees sounded very nice in theory, but their economic and financial results in practice fell considerably short of anticipations. As far as the Bank return was concerned, it showed no sign of any noteworthy degree of deflation. The note issue, which reached its peak at the end of May, at 82,776 million francs, declined, it is true, to 81,128 million francs by the end of July. But during the following two months it increased once more, reaching 82,399 million francs by the end of September. Nor was there any indication of a decline in rediscounts. Indeed, they remained most of the time above the figure reached in the May panic. Curious as it may seem, the very quarters which dictated the pace of deflation for Government, Parliament and the country, failed themselves to deflate.

(3) Bank of France becomes more Accommodating

The explanation of this paradoxical situation lies in the fact that M. Tannery and the Regents of the Bank of France, having forced the Government to deflate, had to pay the price of the service rendered. Notwithstanding statements to the contrary, the French budget remained hopelessly unbalanced even after the deflationary measures were passed. Nor did these measures restore confidence sufficiently to enable the Government to meet the deficit by means of normal borrowing from the public or from the banks. The former con-

tinued to keep aloof from Government securities and the latter were in any case full of Treasury bills to saturation point. In the circumstances the Treasury had to resort to borrowing from the Bank of France. This was not done openly, but under the disguise of adopting a more liberal attitude towards the rediscounting of Treasury bills.

When in January M. Flandin endeavoured to induce the Bank of France to relax its rules, his request was met with stubborn refusal. Once, however, deflationary decrees were passed, the Bank of France was only too willing to comply with the same request, coming as it did from M. Laval. While they suspected M. Flandin of harbouring devaluationary intentions, after the advent of M. Laval they knew they could trust their man, and loosened their purse-strings for his benefit. There followed an orgy of inflationary borrowing of the worst type, the nature and extent of which was duly exposed in Parliament, first by M. Reynaud during a debate in March, then by M. Auriol, after the advent of M. Blum. In the autumn of 1935, however, appearances were kept up, and the relaxation of the rule concerning the rediscounting of Treasury bills was presented as part of a deliberate policy of cheap money. Since that policy had produced satisfactory results in Great Britain, it was a very useful slogan for French politicians, even though conditions in France were totally different. In pursuance of this policy of cheap money, the Bank of France reduced its rediscount rate from the panic level of 6 per cent, to which it was raised in May, to 3 per cent in September. There was no justification whatever for such a change from a strictly orthodox point of view, and indeed it was mildly criticised in orthodox circles on the ground that any such reduction should have been preceded by easier money conditions through repatriation and dishoarding.

(4) Rise in Prices

Week after week the bank return continued to damp optimism among anti-devaluationists regarding the success of M. Laval's deflation. They began to realise that it was one thing to order deflation by decree and another to effect actual deflation in practice, once the process has passed a certain stage. The trend of commodity prices, being the main index of the progress of deflation, was anything but gratifying. With only a few temporary halts the falling tendency of French wholesale and retail prices had been continuous ever since the *de*

facto stabilisation of the franc in 1926. The lowest point was reached in July 1935, when the index number of wholesale prices touched 51·4, the basis being 100 for the average of 1929. It was fully expected that M. Laval's drastic cuts would result in a further sharp fall in commodity prices. The optimistic wing of the orthodox school even expected that there would be a fall to the full extent of 10 per cent. Much to their dismay, they had to witness the index number creeping up month by month throughout the second half of 1935. For August the index number was 52·6, for September it was 53·0, for October 54·5, for November 55·5, and for December 56·5. The advance continued during 1936. If the deflationists turned for comfort to the index of the cost of living, they were equally disappointed. For the third quarter of 1935 that index reached the low level of 84·4, but for the fourth quarter it was up to 86, and during 1936 it continued to advance.

Evidently in practice M. Laval's deflationary effort resulted in a complete failure. Not only was he unable to prevent a rise in prices in France, but he was even unable to prevent French prices from rising faster than the world level. Six months after M. Laval's deflationary decrees the franc was more out of equilibrium with the leading currencies than it had been at the time of the May panic.

(5) The Franc Scare of November 1935

Thus, when the French Parliament met in November, there was indeed very little to be said in favour of the ratification of M. Laval's decrees. The sacrifice had been futile, even from a strictly orthodox point of view. Indeed, the parties of the Left had every intention of opposing the ratification of at least some of the measures affecting small incomes. The Chamber Finance Committee, which met in October, declared itself unwilling to ratify M. Laval's measures without drastic alterations. Thereupon followed another major franc scare. It was expected that M. Laval's Cabinet would be defeated in the Chamber, and the prospects of a Cabinet crisis with devaluation lurking in the background resulted in a renewal of the flight from the franc. Once more the bank rate was raised to the panic level of 6 per cent, and the cheap money policy inaugurated after the end of the May crisis was thrown overboard. The Bank of France lost, during this second franc crisis, gold to the amount of some 6 milliard francs.

Orthodox quarters derived some slight satisfaction from the fact that its loss was not quite so heavy as in May. They inferred the conclusion that the amount of capital available for transfer abroad was nearing exhaustion. This was, however, evidently a case of the wish being father to the thought, for notwithstanding the heavy withdrawals of the last few years, the deposits at French banks subject to withdrawal at sight or at short notice were still very large.

The absurdity of raising the bank rate in order to check the drain was duly illustrated by the fact that, contrary to tradition, the rise was not accompanied by any credit restrictions. As in May so in November the Central Bank actually had to expand credit simultaneously with raising the bank rate. The amount of its rediscounts increased from 8,319 million francs at the end of October to 11,218 million francs at the end of November. At the same time 30 days' advances rose by over a milliard francs. This was, however, inevitable. Confronted with heavy withdrawals of deposits, the banks had to fall back on the Bank of France, and the latter, in order to avoid a banking crisis which would only have aggravated the panic, had to expand its credit facilities. This fact, together with that of the rise in commodity prices and the cost of living, in face of Draconian deflationary measures, shows how completely deflation defeated its object in France.

(6) Radicals' Short-sighted Policy

It would have been to the interest of France if Parliament had followed its first intention and rejected the ratification of M. Laval's decrees. This would, of course, have meant a Cabinet crisis, and the trouble was that M. Laval's opponents were not prepared at that stage to assume the responsibility of the Government six months before the General Election. The Radical Socialist party, which held the key to the position, fully realised that if it were to attempt to carry on the Government without devaluation it would inevitably lose its popularity. The obvious solution would, of course, have been to devalue outright, for within six months the beneficial effects of devaluation would have been sufficiently noticeable to secure the Government the support of the country.

The Radical Socialist politicians were, however, short-sighted enough not to realise this. Notwithstanding the example of Belgium across the frontier—not to speak of the more distant examples of Great Britain, the United States

and other countries which had abandoned the defence of their currencies—the predominant majority of French politicians were still firmly convinced that to devalue before the General Election would be political suicide. The only leading politician who had the courage to declare himself in favour of devaluation was M. Paul Reynaud, who was, however, out of sympathy with his own party. Since the parties of the Left were not prepared to jeopardise their electoral chances, either by devaluing or by defending the franc, they preferred to change their attitude towards M. Laval and to ratify his decrees. At the end of November the second franc crisis of 1935 thus came to a conclusion.

CHAPTER XIV

EXIT M. LAVAL

(1) Hopeless Outlook for the Franc

The experience of the franc crisis of November 1935 conclusively proved (*a*) that notwithstanding M. Laval's deflationary efforts the franc remained highly overvalued and vulnerable; (*b*) that French Parliament and public opinion were not yet ripe for deciding upon a deliberate devaluation; and (*c*) that the unofficial embargoes against speculation, introduced a few months earlier, were effective only while there was no specific reason for speculative activity. The French public remained essentially distrustful towards the franc, not merely because M. Laval's decrees were in danger of being rejected by Parliament, but also because few people were inclined to believe that those decrees, even if ratified, would be sufficient to save the franc. Any unsettling factor was capable of bringing this distrust to the fore, and in the circumstances it was inevitable that the franc should experience a series of crises. Admittedly the technical position was still very strong even after the losses of gold suffered during November. At the end of that month the percentage of gold covered by sight liabilities was only a shade under 70 per cent against the legal minimum of 35 per cent. Obviously the franc was in a position to survive a number of attacks similar to that of November, but there could be little doubt about the final outcome of the struggle.

Anyone with a modicum of foresight could not help forming a definite idea of the fate that awaited the franc. Every now and again there was bound to be a recurrence of the acute crisis, inflicting further losses upon the official gold reserve. During the intervals between two crises the Bank of France might recover some gold but, as the experience of November showed, its losses within a few weeks would be several times the amount recovered in the course of months. After each crisis the technical position would grow weaker and weaker. In addition to the external drain upon the gold reserve, the technical position would also become undermined through the

internal drain caused by the inflationary method of financing the budgetary deficit and by the support which the Central Bank was bound to give to banks whose liquidity was affected by the withdrawals of deposits. Nobody could estimate, even approximately, how long it would be before this dual process of decay broke the resistance of the franc. It was, however, evidently a mere question of time.

(2) Futility and Drawbacks of Prolonged Resistance to Devaluation

This was so glaringly obvious that even ultra-orthodox economists such as M. Charles Rist had to realise it. It was, however, one thing to realise the necessity for devaluation and quite another thing to declare oneself openly in favour of such a policy. The new converts to devaluation took good care to keep their changed views to themselves, and came out with them in the open only after the Socialist victory at the General Election. Meanwhile the chorus of those demanding the maintenance of the franc at its old parity continued to drown the isolated voices of common sense.

And yet every month of the prolonged futile resistance cost France a great deal in the form of further deterioration of her formerly impregnable financial position, and also in the form of a further deterioration of her external political prestige and power. The outflow of gold was gradually reducing the prospective profit the Treasury was to derive from the eventual revaluation of the gold stock. It is true that the counterpart of the loss was represented by an increase of privately owned French foreign assets, so that it was not definitely lost to the national wealth. At the same time there was no guarantee whatever that all the foreign assets would be repatriated after devaluation, especially if it was to be carried out in unfavourable circumstances as a result of its unduly long postponement. Moreover, the profit on the increased value of gold in terms of francs was to go into private hands instead of into the hands of the Treasury.

This was, however, only a smaller evil arising from the delay in devaluing. By far the worst evil was the prolonged atmosphere of tension brought about by the struggle to maintain the franc, and the diversion of the attention and energies of France from the vital problems of national defence to the defence of the franc. Notwithstanding the passing of legislation dissolving the political leagues, the internal situation was anything but reassuring. The country was seething with

discontent, and the nerves of the public were affected by the uncertainty of the monetary outlook. Amidst the budgetary troubles the Government found it increasingly difficult to augment its expenditure on armaments, even though the pace at which Germany was rearming would have demanded increased expenditure on national defence on the part of France. We shall see in later chapters how the prolonged defence of the franc affected the international political position of France, through encouraging Germany to defy the treaties and through inspiring distrust in France's smaller allies regarding the extent of her power, political as well as financial.

(3) A Move towards Devaluation

Admittedly there were influences at work in France to induce the Government to face facts. Senior officials of the French Treasury, such as MM. Baumgartner, Rueff and Maxime Robert, were known to have become ardent supporters of devaluation. Being Government officials they were not, of course, in a position to state their views in public. Their influence and that of other prominent devaluationists had the result that the Government decided in the summer of 1935 to sound London and Washington informally regarding their attitude towards a possible French devaluation. The British and United States Governments were given to understand that, should they decide to stabilise their exchanges definitely at the present level, France would then be prepared to devalue simultaneously with that act of international stabilisation.

Mr. Chamberlain was not, however, prepared to commit himself, either before the General Election or after, to linking sterling definitely to gold. The reply given to the informal French soundings was the same as that given to Belgium some months earlier, namely, that while the British Government would not retaliate to a French devaluation by a deliberate depreciation of sterling, it wished to retain its freedom of action, and to allow sterling to depreciate in case of adverse pressure. This reply was considered inadequate in Paris. In any case, amidst the wave of optimism created in the anti-devaluationist camp by M. Laval's deflationary measures it would have been difficult to induce the Bank of France and M. Laval to agree to devaluation, even as part of a general international stabilisation agreement. Nevertheless, the informal exchanges of views between Paris, London and Washington in the summer of 1935 constituted the first move towards devaluation.

(4) Electioneering Considerations

The fact that in face of the acute crisis of the franc in November 1935 the parties of the Left preferred to continue supporting M. Laval showed that Parliament was not yet ripe to face realities. Even those of its members who were in favour of devaluation were afraid to declare their faith for fear of losing votes at the General Election. Nothing was done to prepare public opinion for devaluation. On the contrary, it was told, day after day, by leading politicians, economists and newspapers, that devaluation was unnecessary and would spell disaster. The politicians of the Left were afraid that, should they declare themselves openly in favour of devaluation, they would be swept out of existence by an indignant public opinion at the next General Election.

It is remarkable how reluctant most people are to learn from the experience of others. The attitude of French public opinion towards devaluation in 1935 was by no means unique or without precedent. In every instance since 1931 when the old parity had to be abandoned, this decision was reached, not under pressure of public opinion, but in face of powerful propaganda against taking that course. In Great Britain in 1931 it was repeatedly stated by Government spokesmen, only a few days before the suspension of the gold standard, that a departure from the old parity would be a major disaster for this country and for the rest of the world. Hardly anybody ventured to contradict this widespread belief. Notwithstanding this, on September 21 the British public received with an obvious sigh of relief the announcement of the suspension of the gold standard. The same experience was repeated in every instance where the old parity was abandoned between 1931 and 1935. The public took the change remarkably well in the Scandinavian countries, in Japan, in the Union of South Africa, in the United States and, more recently, in Belgium. The recurrence of the same experience over and over again failed, however, to convince French politicans, whether Conservative or Socialist, that the risk of unpopularity in consequence of devaluation would be negligible. It is true that the extremist parties, both Fascist and Communist, would have been only too eager to make political capital out of devaluation, but then they were making capital also out of deflation. There was only one man who would have been prepared to take the plunge —M. Paul Reynaud—and he was powerless, with no follow-

ing in Parliament and very little obvious following in the country.

(5) Bank of France's Last Efforts to Retain Control

Government and Opposition were not yet prepared to devalue at the end of 1935. Were they prepared to continue deflating? By then it was evident that the cuts imposed upon the country by M. Laval were not sufficient to restore the budgetary equilibrium. Indeed, the fact that M. Laval's drastic measures were unable to check the progress of reflationary forces conclusively showed the futility of any further deflationary measures. The utter hopelessness of any attempt at restoring equilibrium by means of deflation was realised by everybody except the Bank of France. Its regents, especially MM. de Wendel and de Rothschild, and its Governor, M. Tannery—whom they had succeeded in converting to reactionary orthodoxy—refused to believe that the orthodox remedy of cuts and more cuts could possibly fail. M. Lacour-Gayet, head of the economic department of the Bank of France, was the moving spirit of the reactionary group. Had it depended upon them, they would have imposed on France deflationary cuts several times more drastic than those introduced by M. Laval. Fortunately for France, however, it did not depend on them.

By undertaking to finance the Treasury's deficit the financial clique behind the Bank of France had relinquished the power by means of which, as recently as May 1935, they had bullied M. Flandin into embarking upon a policy of ruthless deflation against his better judgment. Having entered the slippery path of financing the Treasury's deficit by deflationary means, they were not in a position to call a halt. They did not, however, admit defeat. Throughout December and January, when the existence of a huge deficit, in spite of the recent economic measures, was becoming increasingly obvious, they did their utmost to persuade M. Laval to repeat his all-round cuts. But this time M. Laval was not prepared to comply with their request. Being an astute politician, he realised what it would have meant to enforce such measures on the eve of the General Election. When he issued his decrees in the summer he did so on the assumption that during the eight months or so that separated him from the General Election he would be able to live them down in the eyes of the electorate. To repeat the same orgy of deflation two or three months before the General Election would evidently have been political suicide.

(6) "Après Moi, la Déluge"

In January 1936 M. Laval found himself confronted with three alternatives. The first, that of the devaluation of the franc, he rejected without hesitation. The second was to follow the Bank of France's advice and deflate further. That again he was not prepared to do. The third alternative was to carry on without deflation or devaluation, and to go to the country with the full burden of the failure of his deflationary drive. That again was contrary to the principles of political wisdom as interpreted by M. Laval. He therefore chose a fourth alternative. He ran away, leaving it to his successor to struggle on in the mess he had created, and to share with him the responsibility for the failure of deflation. In choosing this course M. Laval only followed the example of M. Theunis, the Belgian Prime Minister, who resigned in March 1935 because he was not prepared either to devalue or to deflate.

It is true that the immediate cause of M. Laval's resignation was the increase of Parliamentary opposition to him, but he was an astute enough politician to be able to continue steering between parties had he wanted to do so. Just as he was able to obtain his majority in June, in November and also in December, when his position was once more threatened, this time, on account of the foreign policy pursued, he would have been able to secure a majority also in January. But he thought it wiser to relinquish command before the decisive battle that was shortly to come.

When in 1922 M. Loucheur returned to Paris from the Cannes conference which had to break up because of the resignation of the French Government, he replied, to a reporter's questions about reparations: "*Je m'en——! Je ne suis plus Ministre!*" It is in the same spirit that M. Laval left the care of the deflation *v.* devaluation dilemma to his successor. He might well have adopted Louis XV's famous saying: "*Après moi, la déluge!*"

PART III
PROGRESS OF REFLATION

CHAPTER XV

DEFLATION REVERSED

(1) Rising Prices

We have seen in Chapter XIII that, notwithstanding the unprecedented drastic measures of deflation taken by M. Laval during the summer of 1935, there was in practice a reversal of the deflationary trend throughout the second half of that year. I quoted the French index numbers of wholesale prices and cost of living to show the extent of reflation in France that took place in spite of the Government's deflationary efforts. The turn in the tide was partly due to causes special to France, but to a large extent it extended over the whole group of countries of the Gold Bloc and its satellites. In Holland the index number of wholesale prices, after having declined to 60·8 in March 1935, rose to 63·5 by October of that year. In Switzerland the lowest point was also reached in March, when the wholesale index was 61·2, while by October it had risen to 66·1. The Swiss cost of living index number advanced from 78·3 in April to 80·7 in November. In Spain the wholesale index rose from 99·0 in July to 103·3 in December. In Turkey the recovery of prices was much more pronounced. The lowest point was reached in May 1935, when the index was at 51·2, while by December it was at 64·1. The Turkish cost of living index rose from 67·6 in August to 72·2 in December. In Germany the wholesale index advanced from 73·4 in March to 75·4 in December. Evidently throughout the second half of 1935 there was a rising trend in prices in countries which maintained their old parities.

In most of these countries the policy pursued by the Government was contradictory to a remarkable degree. They were preaching deflation, but at the same time they were to a greater or less extent reflating. On the one hand they were attempting to obtain equilibrium by destroying trade and purchasing power; on the other hand they were trying to make the destruction good by creating employment through public works. In Germany, needless to say, any pretence at deflation was abandoned, though the Government continued to keep

wages down in face of the rising prices and cost of living. Public works and rearmament expenditure constituted a huge reflationary factor whose real effect upon prices is shown only inadequately by the wholesale index, which shows a rise from the annual average of 68·0 in 1933 to 75·4 for December 1935.

(2) Public Works Expenditure neutralises Deflation

One of the reasons why deflation could not be pursued indefinitely was the political necessity for Governments to mitigate the unemployment created by deflation. To that end public works were undertaken in almost every deflationary country. This is very much against the orthodox rules. The only way in which prices can effectively be forced down is through destroying trade and purchasing power. This rule has never been admitted by orthodox economists, but it is none the less true. If a Government destroys trade and purchasing power with one hand and attempts to create trade and purchasing power with the other, deflation cannot be effective. To the extent to which the Government is successful in stimulating trade and creating purchasing power the effect of its deflationary efforts are offset. Obviously it would be wiser, even from a strictly deflationary point of view, to apply a reduced degree of deflation rather than to apply an advanced degree and counteract it to some extent by public expenditure. But then the requirements of demagogy have to be satisfied. The unpopularity of deflationary measures has to be mitigated by throwing a sop to public opinion in the form of employment-creating expenditure. By such means the deflationary measures can be made more palatable for popular consumption.

The same is true concerning the cheap money policy adopted or attempted by several deflationary Governments. To the limited extent to which it can be successful while a currency is overvalued it counteracts the results of deflation. Nevertheless, the war-cry of cheap money is a popular one, and few deflationary Governments have refrained from making use of it at various stages of their deflationary policy.

(3) Political Limits of Deflation

It has been stated at times that under dictatorship it is easier to deflate, as the Governments need not take public opinion into consideration in enforcing unpopular measures. In reality, in no democratic country, with the possible exception of the United States, has deflation been accompanied by

such a high degree of deliberate reflation as in Germany and Italy. In both countries the extent of public works expenditure in recent years was incomparably larger than in democratic deflationary countries. As a result, the extent of reflation was also considerably larger. We have seen that in Germany prices have been rising ever since the advent of the National Socialist régime, as a result of the reflationary policy which sought to mitigate the evils of deflation necessitated by the defence of the reichsmark. In Italy prices began to rise at the end of 1934 and are known to have been rising ever since, even though the publication of index numbers was suspended at the beginning of the Abyssinian war. We propose to return to this subject in later chapters. Here let it be sufficient to point out that there are political limits to deflation under dictatorship as well as under parliamentary democracy.

In themselves, the political factors would have been unable to bring about reflation in France and other countries which were defending their old parities. There are, however, also financial limits to deflation. The experience of 1935 has conclusively disproved the belief that non-stop deflation can be carried on indefinitely provided that political resistance to it can be overcome. This proviso in itself is sufficient to rule out the possibility of readjustment of a large disequilibrium through non-stop deflation, for political opposition to such a course could never be finally overcome. But even if we were to assume that the nations would meekly submit to endless deflation, depression and suffering, obeying the wishes of certain Professors of the London School of Economics, this would not mean that deflation could continue indefinitely. Beyond a certain stage it would automatically set into motion factors tending to reverse its course.

(4) Budgetary and Monetary Limits

Prolonged deflation leads inevitably to a large and growing budgetary deficit, both through the rigidity of certain expenditure items and through the decline in taxable incomes. For a time the deficits can be financed through an increase of the public debt by means of long-term or short-term borrowing. Beyond a certain point, however, neither the public nor the banks are willing or able to take up any more Government securities. Once that stage is reached the Government has to inflate through borrowing from the Central Bank. We have seen in an earlier chapter that this is what actually took place in France during 1935.

We have also seen, in following the course of events in France, that the monetary limits of deflation began to operate also through the necessity of supporting banks affected by withdrawals of deposits through the flight from the national currency. Admittedly, the orthodox rule is to deflate irrespective of consequences, but I doubt whether, confronted with a major banking crisis, even the most extreme dogmatists of orthodoxy would dare to preach this doctrine. That is, from their University chairs they would undoubtedly demand 100 per cent deflation, but if the responsibility for the execution of that policy rested with them, they would take a different view. Rather than allow leading banks to collapse they would admit the necessity of support, even though that support would reverse deflation.

(5) Reflationary Effect of Distrust in Stability

In addition to the political and financial limits of non-stop deflation there are also economic limits. The public is in many ways wiser than its responsible leaders. It duly realised in the Gold Bloc countries that resistance to devaluation could not continue for ever. As a result, many people exported capital, or hoarded gold or foreign notes. Others resorted to a different method of hedging. They purchased various kinds of non-perishable commodities, real property, etc. The small man who had no money for capital investment was induced by the anticipation of devaluation to cover his future requirements of consumption goods by advance purchases. This is, in fact, what actually took place in France and other countries of the Gold Bloc, and it was to a large degree responsible for the rising trend of commodity prices during the second half of 1935. The index of production in France increased from 66·0 in May 1935 to 68·8 at the end of that year, and continued to increase during the first few months of 1936. As rearmament on a large scale did not begin until 1936, this increase was largely the result of increased purchases of consumption goods. This is evident from the fact that while the index of production in the French engineering industries advanced only from 60·5 to 61·1, and the index for motor-car production from 60·9 to 61·8 during the last three-quarters of 1935, the index of production of textile goods advanced from 64·1 to 77·2.

To a large degree the flight from the franc and other gold currencies assumed the form of purchases of consumption goods. This is the reason why deflation did not aggravate the

trade depression any further. Thus the reflationary forces set in motion by the obvious overvaluation of the currency mitigated to some extent the economic consequences of deflation. In doing so, however, they annulled the effect of deflation upon prices.

CHAPTER XVI

PRESIDENT ROOSEVELT'S REFLATION

(1) Deliberate Raising of Prices

If there is one name to which the deliberate policy of reflation can be linked it is that of President Roosevelt. Among all the statesmen holding responsible positions throughout the world he was the only one to realise the necessity of taking action in order to provoke a rise in commodity prices. Long before his advent reflationary forces were working in various parts of the world, especially in the countries of the Sterling Bloc. They were, however, working not as a result of any deliberate policy but independently of the Government's wishes, and to some extent against the Government's wishes. The depreciation of sterling took place as the inevitable consequence of circumstances over which the Government had no control. Another reflationary factor in Great Britain, the decline of interest rates, took place with the support and approval of the authorities, but the object was by no means to provoke reflation. Indeed, the extent to which these factors resulted in actual reflation was very moderate before the advent of President Roosevelt. Between 1931 and 1933 the price level in the United Kingdom remained practically stable, and reflation made no material progress in any other part of the world with the exception of such countries as Japan, Greece, Chile, etc., whose currencies depreciated to a larger degree than sterling. Even in those countries depreciation was not engineered deliberately for the purpose of bringing about reflation, but was brought about by the force of circumstances, much to the dismay of the authorities.

Had President Roosevelt nothing else to his credit than his ability to break that pathological fear of rising prices which made other statesmen shrink from the right solution, he would nevertheless have rendered immeasurable service to mankind. Before he embarked upon his deliberate and declared policy of reflation, a rise in prices was usually represented as something disastrous which had to be prevented at all cost. It is true that before 1931 the British authorities had based all

their hopes of maintaining sterling at its old parity without having to deflate to that end on the possibility of a rise in world prices. No action whatsoever was, however, taken by any monetary authorities to that end. President Roosevelt was the first to declare himself openly in favour of a monetary policy aiming at a deliberately engineered rise in prices, and he was the first to have the full courage of his convictions.

(2) Results of Reflationary Policy

The suspension of the gold standard in the United States and the deliberate depreciation of the dollar were among the means to that end. The policy of raising the price of gold, the abolition of the gold clause, the large relief payments, extensive public works schemes and the silver-buying policy, were other means. During the first two years of his régime, President Roosevelt was experimenting with these various devices in addition to his New Deal policy, which in itself aimed at raising wages. The result of all these efforts was a rise in commodity prices in the United States by some 20 per cent between March 1933 and March 1935. At the same time the index of industrial production increased from 53·8 for 1932 to 75·6 for 1935. Admittedly President Roosevelt made many mistakes in the course of his experiments. Very often he did the right thing in the wrong way, and allowed himself to be influenced by the wrong people. Nevertheless, in the face of the recovery of the United States from the depth of depression, these mistakes disappear into insignificance. Unquestionably his determined action undertaken in an unconventional spirit unfettered by orthodox doctrines saved the United States from a complete collapse and chaos. In a negative sense his policy was undoubtedly successful.

In a positive sense the success of his policy was not nearly so unqualified. Admittedly, between 1933 and 1935 he succeeded in reducing to some extent the burden of private indebtedness, but to a large degree this was done at the cost of increasing public debt. The burden was merely shifted from the shoulders of citizens in their individual capacity to the shoulders of citizens in their capacity of taxpayers. Although the number of unemployed was reduced from the beginning of 1933 till the end of 1934 from 26 per cent to 21 per cent of the total employables, this result was not in proportion to the tremendous deliberate reflationary effort made for the purpose of improving trade. During the same period the proportion of unemployed in Germany was reduced from

(3) Reflationary Efforts Slowing Down in 1935

In the course of 1935 the President's reflationary zeal slackened somewhat. It is true that during the first half of the year he was pursuing his silver policy with a vigour worthy of a better cause. It is also true that his public works expenditure and his relief payments did not slacken. At the same time his monetary policy in the narrower sense of the term was becoming increasingly orthodox. He was no longer the enthusiastic champion of the debtor classes, which were still in need of relief through higher commodity prices. Admittedly the problem of private indebtedness was no longer as burning as it had been two years earlier. To some extent it had become reduced through the rise in commodity prices, through the various forms of official relief actions, and also through default or compositions with creditors. The burden remained nevertheless excessive. Moreover, as the budgetary deficit remained very high and the public debt continued to increase rapidly, a time had to be envisaged when the increased taxation would take the place of the reduced burden of private indebtedness.

Doubtless President Roosevelt had the courage of his convictions in launching out various reflationary experiments. He had not, however, the courage of his convictions to carry most of these experiments far enough to obtain the desired result. It is true that he was spending a record number of milliards on public works and relief payments. At the same time, however, he followed the advice of his orthodox Treasury officials and bankers in financing that deficit by orthodox methods, thereby neutralising to a large degree the reflationary effect of his expenditure.

(4) American Public not Inflation-Minded

Had he pursued a less orthodox method of Treasury financing, a fraction of the actual amount expended would have produced a more pronounced effect upon the price level in the United States. As it was, the inflationary pronouncements he made from time to time were unable to carry much conviction. The American public simply refused to become inflation-minded, although this was an essential condition for a pronounced rise in commodity prices. In this respect the attitude of the American public was similar to that of the public in the European belligerent countries during the first two years of the war when, in spite of the presence of wholesale inflation, commodity prices were reluctant to rise.

What the President ought to have done was to continue the depreciation of the dollar instead of stabilising it at 59 cents in January 1934. At the same time the depreciation ought to have been accompanied by a certain amount of crude currency inflation in the form of the issue of " greenbacks ". The evidence of such inflation would have induced consumers to cover their requirements well in advance. The demand thus created would have induced merchants to increase their stocks and manufacturers to increase their output. Within a short time the United States would have witnessed brisk business activity. Prices would have risen sufficiently and unemployment would have declined sufficiently to obviate the necessity for gigantic expenditure on public works and relief payments. Private indebtedness would have been reduced without a corresponding increase in public debt. It is a pity that President Roosevelt, having made a courageous start in 1933, should have begun to vacillate between monetary radicalism and orthodoxy.

During 1935 President Roosevelt had more reason than ever to move towards monetary radicalism instead of reverting to orthodoxy. For the reactionary elements which during the first part of his régime were stunned by the vigour of his action and cowed by fear of his heavy hand were beginning to reassert themselves. They found a formidable stronghold in the Supreme Court of Washington, whose reactionary judges never missed an opportunity to put a spoke in the wheel of the New Deal. Time and again throughout 1935 and 1936 the Supreme Court passed judgments invalidating the legislation essential for the New Deal. As a result of their various rulings the efforts of the Administration to attain recovery through spend-

ing and intervention were virtually frustrated. Evidently the President's reply to these reactionary victories ought to have been a more radical monetary policy. Instead he slackened his reflationary efforts except in the direction in which they would not bring a net reduction of a lasting nature in the burden of fictitious wealth.

(5) President Roosevelt's Achievements

Having said all this, it is necessary to reaffirm the immeasurable merits of President Roosevelt in having inaugurated deliberate reflation and in having succeeded in actually turning the international tide. It was from his advent to office that the world price level in countries which had detached themselves from gold began to advance. The reduction of unemployment outside the United States was to a large extent the indirect consequence of President Roosevelt's reflationary policy. The initiation of the recovery of raw-material-producing countries over the five continents from a desperate depth of depression was to a very large degree his achievement. It was he who opened the way to the reflationary current *which subsequently* extended over the whole world. Its effect would have been more rapid and more universal but for the stubborn resistance of the Gold Bloc countries to devaluation and but for their deflationary efforts, which to some extent neutralised the effect of American reflation upon world prices. Without his decisive action in 1933 the United States would have witnessed a crisis of unprecedented magnitude with all its destructive effect on purchasing power, leading to another world-wide slump similar to the one initiated by the Wall Street crisis of 1929.

During 1935 the reflation initiated by President Roosevelt continued in the United States notwithstanding the increasingly orthodox tendencies of his monetary policy. The index of wholesale prices in the United States advanced from 82·7 to 84·9. The index of industrial production advanced from 76·5 to 87·4. The index of engineering output advanced from 42·4 to 61·3, that of motor-car production advanced from 77 to 93·3. To a large extent this increase was due not to any reflationary monetary influences but to rearmament, which began to make itself felt as the predominant factor in world economics. This is indicated by the fact that during the first half of 1935 the general industrial index actually declined from 76·5 to 72·3. It was during the second half, and more especially during the last quarter, that the increase took place. The

same observation is true concerning the index of engineering production, which advanced only from 42 to 47 during the first five months of the year, and concerning motor-car production, which declined from 77 to 63·7 during the same period. About the rôle of rearmament as a factor of recovery in the United States, however, more will be said in Chapter XLVIII.

CHAPTER XVII

MR. CHAMBERLAIN'S CONVERSION

(1) Comparison with President Roosevelt

We have seen in the last chapter that the actual result of reflation in the United States was less than the reflationary efforts made since the advent of the Roosevelt régime. We shall see in this chapter that in Great Britain, on the other hand, the results of reflation outran the actual official reflationary efforts. While in the United States we had the maximum of intervention with a comparatively small positive result, in Great Britain we had a relatively moderate degree of intervention with a comparatively substantial result. It must be added, however, that the result of British reflation was, to a large degree, the consequence of President Roosevelt's reflation.

Reflation in Great Britain is coupled with the name of Mr. Neville Chamberlain, who virtually controlled the country's monetary and financial policy under the Premiership of both Mr. Ramsay MacDonald and Mr. Baldwin. Temperamentally, he and President Roosevelt were at opposite poles. President Roosevelt was by nature a Radical in the sphere of finance; Mr. Chamberlain was essentially Conservative. President Roosevelt was very keen on experimenting with the latest schemes put forward to him; Mr. Chamberlain was unwilling to depart from the system tested by experience. President Roosevelt inaugurated his changes of policy with the maximum of publicity; Mr. Chamberlain avoided publicity to such an extent that changes of policy could be ascertained for the most part by inference only. In the course of his term of office President Roosevelt was inclined to move from Radicalism towards Conservatism in the sphere of monetary policy. Having tried in 1933 and 1934 some of the most reckless of schemes, he was inclined to become more cautious from 1935 onwards. Mr. Neville Chamberlain, on the other hand, having assumed office as an essentially orthodox Chancellor of the Exchequer, became increasingly progressive in the course of his term of office, until the end of 1936.

(2) An Orthodox Start

Indeed, when in 1931 Mr. Chamberlain succeeded Lord Snowden at the Exchequer, he was nearly as orthodox as Mr. Montagu Norman himself or, which is almost the same thing, as Lord Snowden. He was in favour of defending sterling at its old parity, and it was only because the situation got out of control in September 1931 that he decided to suspend the gold standard. For him this move was not a matter of policy but sheer necessity. The fact that when the gold standard was suspended the Bank of England raised its rediscount rate to 6 per cent showed that the authorities did not mean the depreciation of sterling to produce reflationary results. Indeed, during the first phase of his term of office Mr. Chamberlain was definitely deflationary. Amidst the crisis he introduced drastic new taxation and balanced the budget, and had the bank rate raised to a level at which it was calculated to prevent the depreciation of sterling from being accompanied by an inflationary boom.

When at the beginning of 1932 the tide turned and there was a flight to the pound, Mr. Chamberlain did not unduly exert himself to prevent this movement from bringing about a sharp recovery of sterling. It is true that he established the Exchange Equalisation Account, but both before and after its establishment a buying pressure on sterling was allowed to produce an unwanted appreciation which, however pleasing it may have been from a strictly orthodox point of view, was anything but helpful from the point of view of British trade. Ever since its establishment the Exchange Equalisation Account has pursued the rule not to allow sterling to depreciate more than is technically inevitable. Notwithstanding what is often said abroad, Mr. Chamberlain did not make use of the Exchange Equalisation Account for reflating or for securing advantages to British exporters. He was, and still is, far too orthodox to engineer deliberate depreciation of sterling, or even to abstain from resisting a natural depreciation so long as he has the means for doing so.

(3) Cheap Money Policy

Nevertheless, he gradually departed from his orthodoxy in other directions to no slight degree. To begin with, even at the end of 1931 he had successfully resisted pressure in favour of an early stabilisation of sterling after its first depreciation in September and October. Having learnt the lesson of the

past, he decided to avoid repeating the mistake of 1925 by stabilising in circumstances which did not provide safeguards for the maintenance of stability without undue sacrifices. In this respect Mr. Chamberlain's policy has been consistent ever since September 21, 1931.

Another direction in which his departure from orthodoxy manifested itself at an early phase was in his attitude towards cheap money. He maintained the high bank rate so long as there appeared to be a danger of a heavy depreciation of sterling. When, early in 1932, he realised that the tide had turned, he began to favour a deliberate policy of cheap money. The bank rate was gradually reduced until it reached 2 per cent in June, at which figure it has been maintained ever since. It is difficult to say how far this decline of interest rates was due to natural influences, especially to the influx of foreign funds, and how far it was the result of deliberate efforts to pump money into circulation. Personally I am convinced that even in the absence of any deliberate policy cheap money was bound to come, although it might have come more slowly. Once the interest rates were brought down to their low level it was Mr. Chamberlain's declared policy to keep them there. In this respect he departed considerably from the orthodox school, according to which cheap money only has justification during acute depression, and the first signs of a trade revival should be accompanied by a rise of money rates. Mr. Chamberlain refused to allow himself to be influenced by any such nineteenth-century principles. He adopted the rule that money should be maintained at a low level until unemployment had become completely absorbed. In this respect he appears to have accepted the guidance of Mr. Hawtrey, much to the horror of the orthodox school, which was brought up in the traditions that dear money was to be regarded as being synonymous with sound finance.

(4) Orthodox Advice Rejected

When towards the end of 1934 and early in 1935 speculative activity became noticeable in some minor commodities such as pepper, shellac and monkey nuts, the orthodox camp considered that the time had arrived for an attack on cheap money. Professors of the School of Economics, and high officials of the Bank of England, uttered solemn warnings against the coming boom, and suggested a rise in the bank rate to check it in time. Mr. Chamberlain refused to listen to their advice. His common sense told him that the agitation in the orthodox camp was a

false alarm, as with unemployment still around two million there could be no question of a general speculative boom. He must also have felt that it was hardly worth while to bring about a relapse in every branch of trade for the sake of checking speculation in commodities whose relative importance to the total trade was probably less than 1 to 100,000.

Events fully justified his attitude. The boomlets in the minor commodities fizzled out without causing much damage. The gradual recovery continued slowly, without developing any speculative tendencies, throughout 1935 and 1936. Evidently it would have been a pity to check this much-needed recovery for the sake of checking the boomlets in the minor commodities, which in any case came to an end without such drastic intervention.

(5) How Far was Cheap Money Deliberate?

A highly controversial question is how far cheap money was the result of deliberate policy and how far it was responsible for the recovery experienced during 1932 and onwards. As I have already pointed out above, to a very large degree the low money rates were due to natural causes. The absence of adequate demand for credit, coupled with the increase of resources through the influx of foreign funds, would have resulted in easy money conditions even if the attitude of the authorities had been one of strict neutrality. Indeed, apart from pumping money into circulation during the spring of 1932, until about the second half of 1935 the cheap money policy consisted largely of abstaining from doing anything which would make money dearer. It is only since the summer of 1935 that signs of a deliberate policy of expansion have become noticeable.

Regarding the effect of cheap money on trade revival, it is necessary to bear in mind that the depreciation of sterling and the adoption of protective customs duties were contributory factors of at least equal importance to that of cheap money. The latter in itself could have achieved but little, though admittedly in the absence of cheap money the depreciation of sterling and customs duties would have produced but limited results. By far the most important factor responsible for the recovery was the rising trend of commodity prices brought about by President Roosevelt's reflationary policy in the United States from 1933 onward. Until he assumed office the depreciation of sterling was accompanied by a fall in the world market price of commodities, but from the spring of 1933

onwards a relatively moderate but none the less distinct upward trend became noticeable. Even this in itself would not have carried recovery very far. The pace of recovery became accelerated only during 1935, as a result of world-wide rearmament.

(6) Active Expansionism in 1935–6

In pointing out these facts I do not seek to minimise the extent to which the credit for recovery is due to Mr. Chamberlain. After all, it was he who, having resisted the demand for a higher bank rate early in 1935, embarked upon a policy of deliberate expansion of credit in the summer of the same year. By gradually transferring substantial amounts of gold from the Exchange Equalisation Account to the Bank of England, he secured an adequate basis for the credit expansion necessitated by the trade revival. But for this action, the trade revival would have been accompanied by a rise in short-term as well as long-term interest rates, which again would have reacted unfavourably upon the pace of credit expansion, and by the autumn of 1936 it would have led to a setback in trade.

Mr. Chamberlain's budgetary policy also underwent a change in the unorthodox direction in 1935. Until that year he had pursued a strictly orthodox budgetary policy, notwithstanding his unorthodox monetary policy. He refused to embark upon public expenditure for the sake of accelerating the pace of recovery, or even for the sake of solving some burning problems such as slum clearance, relief of road congestion, etc. Early in 1935, however, he began to show signs of relaxing his orthodox attitude towards public works. Several important schemes had been adopted, and even if the actual amount involved was but a fraction of President Roosevelt's gigantic public expenditure scheme, it constituted an important departure from the principle of orthodox budgetary policy. By the autumn of the same year the conventional budgetary principle had to be thrown overboard altogether, as a result of urgent rearmament requirements. Reflation through public expenditure had to be adopted as the basis of British policy not so much by choice as by sheer necessity. Nor did Mr. Chamberlain show any inclination to cover expenditure by means of additional taxation, even though he made a gesture to that end in the budget of 1936–37.

(7) A Gradual but Lasting Conversion

Mr. Chamberlain's conversion in favour of reflation was gradual—hardly perceptible. While President Roosevelt allowed himself to be persuaded easily to change his policy, it took a long time for Mr. Chamberlain to discard his former orthodoxy. Nor could his change of policy be attributed to the persuasive powers of any one particular Treasury official, or anyone attempting to exert influence from the outside. While President Roosevelt was easily influenced by members of his " brain trust " during their brief tenure of office, Mr. Chamberlain yielded only with difficulty and only under the inescapable logic of facts. Doubtless he had at his disposal the advice of Treasury officials, and there can be no doubt that he benefited by his association with such first-class brains as those of Sir Frederick Phillips, Mr. Hawtrey, Mr. Waley, Sir Richard Hopkins, Sir Frederick Leith-Ross, etc., but to a large extent he worked out his own salvation in face of the orthodox influence on the part of Mr. Montagu Norman and various other senior members of the banking community and in spite of the orthodoxy inherent in his conservatism.

Mr. Chamberlain's conversion was not an easy process, but once accomplished its effect may be relied upon to be lasting. In the case of President Roosevelt we have to be prepared for any surprise. He may become ultra-orthodox at 24 hours' notice. Indeed, if Mr. Morgenthau had his way, the monetary policy of the United States would by now be essentially orthodox. In the case of Mr. Chamberlain we know where we are. Having gradually become converted in favour of a progressive policy, he can be relied upon to continue to pursue that policy until it has achieved its end. He is not likely to allow himself easily to be persuaded to revert to orthodoxy.

CHAPTER XVIII

DR. SCHACHT REFLATES UNDER PROTEST

(1) Unintentional Reflation in Germany

Ever since the advent of the National Socialist régime in 1933, Germany has been the scene of wholesale reflation. While nominally the reichsmark was retained at its old parity, in reality it gradually depreciated both internally and internationally. Internally the rise in prices, brought about partly by the expansionary policy pursued by the Government and partly by the inadequate raw material supply, reduced the purchasing power of the reichsmark to no slight degree. Official index numbers of wholesale prices and of the cost of living do not adequately indicate the degree to which the reichsmark has depreciated internally since 1933. Internationally a large part of Germany's foreign trade has been conducted with the aid of various types of blocked currencies, which have always been at a discount and whose discount has been widening gradually and almost uninterruptedly, and with the aid of export subsidies which amounted in practice to the depreciation of the currency.

The degree of reflation in Germany can be compared only with that experienced in the United States during the same period. The difference is that while President Roosevelt deliberately aimed at raising commodity prices in order to reduce the burden of indebtedness, the German Government had no such end in mind. On the contrary, it used all its power to moderate and, if possible, prevent the rise in prices. Reflation in Germany was not the end in itself, but the necessary evil that accompanied the Government's efforts to create employment. From 1935 onwards even this object faded into the background. The main object was to rearm as rapidly and as extensively as possible. Since it was impossible to create employment by the million, or to rearm on a gigantic scale, without at the same time reflating, the authorities had to put up with reflation, but they did their utmost to minimise its effects upon prices and the value of the reichsmark. Indeed, there was no reason in Germany for wanting a rise in prices, since indebtedness was far from excessive.

(2) Public Works and Rearmament

Reflation in Germany is associated with the name of Dr. Schacht, the President of the Reichsbank, who subsequently combined this office with that of Minister of Economy in the National Socialist Government. It is an irony of fate that the man to whom the stabilisation of the German currency was chiefly due should have to undertake a policy whose logical outcome is bound to be sooner or later the abandonment of the parity at which he stabilised the currency. Let it be understood from the very outset, however, that Dr. Schacht has undertaken the execution of the National Socialist policy only unwillingly, against his own judgment. Although he has repeatedly changed his political allegiance during his career, in one respect he has not changed. He began as an orthodox banker and to this very day he is first and foremost an orthodox banker. The policy he has favoured throughout his career is one of maintaining the stability of the reichsmark by deflationary methods. This view was not, however, shared by the National Socialist Government. After all, it was the deflationary policy pursued by Dr. Brüning in 1931 that prepared the way for the advent of the National Socialist régime by raising the number of unemployed to something like six millions. The success of the National Socialist régime depended upon its ability to reduce unemployment. Accordingly, ambitious public work schemes were elaborated, requiring milliards of reichsmarks. At the same time it was decided to spend additional milliards on rearmament, proceeding at first on a relatively small scale, under disguise, but subsequently on an unprecedented scale and openly.

How was this money to be found? Certainly not by taxation. It was impossible to balance even the ordinary budget out of current revenue, let alone the huge capital expenditure embarked upon. Nor was it possible, to begin with, at any rate, to raise the funds required by the issue of long-term loans to the public. The resources of the capital market were exhausted by the prolonged depression, and investors were not keen on taking up new Government issues. In the circumstances there were only two alternatives. One was to finance the public expenditure by means of increasing the short-term indebtedness, and the other was to finance by means of crude inflationary methods.

(3) Dr. Schacht's Reluctance to depart from Orthodox Finance

Dr. Schacht's position was by no means easy. Having been appointed President of the Reichsbank soon after the advent of the National Socialist régime, and Minister of National Economy after the London Conference of 1933, he was called upon to provide for the financing of the National Socialist programme of public expenditure. If he had had his own way, he would have cut down public expenditure to the figure of current revenue and would have concentrated his efforts upon further reducing the cost of production. There was, however, no choice. He had to execute a policy of which he strongly disapproved. He undertook this task under protest. Time after time he made efforts to check or at least moderate the flow of money on public expenditure, but the forces opposing him proved to be too strong for him. Not being a National Socialist, he was not popular in the Party, and even though the permanent Civil Service and the Reichswehr were theoretically behind him, in practice this would have meant nothing except in an extreme situation. When he found that his protests were of no avail, he tendered his resignation, but Hitler is understood to have replied that the alternative to the official position he was entrusted with was the concentration camp. Thus to some extent, at any rate, Dr. Schacht carried out the National Socialist policy under compulsion.

Nevertheless, it must be admitted that he carried out that policy with extreme skill. The method by which he succeeded in financing the huge public expenditure between 1933 and 1937 compels admiration, even from his opponents and from those of the National Socialist régime. Untold milliards were spent on unproductive capital expenditure in a country whose capital resources were far from plentiful, without leading to any crude currency inflation. Dr. Schacht succeeded in establishing a vicious circle through which the money spent invariably came back again and again to the Government and became available for spending over and over again.

(4) How Public Expenditure was Financed

In the first instance public works and rearmament were financed with the aid of so-called " employment-creating bills ", which were bills drawn upon the Treasury of the Reich and eligible for rediscount by the Reichsbank. The idea of the Central Bank rediscounting Treasury bills on a large scale must

have been repugnant to Dr. Schacht's mind, but before very long it became evident that there was no need for the Reichsbank to carry permanently very large amounts of these employment-creating bills. The wholesale expenditure on public works and rearmament brought about a revival of trade and an accumulation of funds which enabled the industrial firms to carry these bills as their liquid reserve, and the banks to take up increasingly large amounts of them. A large amount of their assets, which had become frozen during the crisis of 1931, became released as a result of the trade revival, and since this trade revival was financed by these special bills instead of the ordinary bank accommodations, the resources of the banks became available for investment in those bills. The Reichsbank also gradually became relieved of the burden it had had to assume jointly with the Gold Discount Bank and the Akzept-Bank, created in 1931, and its resources became available to an increasing degree for financing public works and rearmament. What happened was that frozen commercial and financial assets were replaced by Treasury bills.

The volume of the floating debt could not, however, be increased indefinitely. It was essential that before saturation point was reached part of it should be consolidated. At this stage it would have been idle to call upon the general public to subscribe to long-term Government loans. The German authorities resorted, therefore, to a method which is possible only in a highly disciplined integralist State—I use the word in preference to the clumsy term " totalitarian "—namely, by compelling banks, savings banks and insurance companies to convert some of their assets into long-term Government loans. From time to time they were called upon to take up tranches of, say, half a milliard reichsmarks of a new issue. They were able to do so because public expenditure led to an accumulation of bank balances, savings deposits and insurance funds. The money spent by the Government found its way to banks, savings banks and insurance companies and, through the compulsory subscription to Government loans, it found its way back again to the Government. By such means large portions of the floating debt became consolidated. Nobody knows, of course, how much remains to be consolidated, and one of Dr. Schacht's grievances was that at any given moment he himself was unable to ascertain the total outstanding amount. The process of consolidation may possibly not have kept pace with the increase of the volume of floating debt, but the situation has never yet got out of control.

(5) Dr. Schacht's Position

Dr. Schacht's position, in spite of the success with which he carried out the policy he disapproved of, became from time to time precarious, owing to his efforts to moderate the flow of expenditure. His endeavours to cut down the amount spent on propaganda abroad incurred the hostility of the Party, and on various occasions the influences working against him nearly succeeded in overthrowing him. Herr Hitler realised, however, that whatever Dr. Schacht's views might be he was indispensable to National Socialist Germany. For this reason, while declining to avail himself of Dr. Schacht's advice of moderation in expenditure, he retained Dr. Schacht in his service, even though he was subordinated to General Goering. How far this arrangement is merely a formal concession to the extremists of the Party and how far Dr. Schacht retains the actual power remains to be seen.

The vicious circle through which the money finds its way back to the Government has been brought as near as possible to perfection by limiting the dividends of joint-stock companies to 6 or 8 per cent per annum. The surplus has to be reinvested in Government securities. Thus most of the profit made on public works and rearmament returns to the Government in the form of loans. The amount saved by wage-earners finds its way to the Government through subscriptions to Government issues by savings banks and insurance companies, while the liquid reserves of business houses created through trade recovery find their way to the Treasury through the Government loans taken up by the banks. Moreover, even the general investor is now more inclined to take up Government loans than he was before.

(6) Is the Vicious Circle likely to Break?

Thus public works and rearmament are financed in Germany without having to resort to crude inflationary borrowing from the Central Bank, except temporarily, for filling in the time lags between the various stages of the progress of funds within the vicious circle. The reason why this vicious circle can operate so smoothly is that there is virtually no hoarding of notes in Germany. Should a wave of distrust arise it would lead to hoarding, which would break the vicious circle, and relatively moderate reflation would give way to crude inflation. Dr. Schacht continues to warn the authorities against overstressing their policy and thereby giving rise to such a wave

of distrust. He even voiced his fears of such developments in public statements, and this was largely responsible for the arrangement by which he became subordinated to General Goering. So far his warnings have proved to be unfounded and reflation in Germany continues without leading to any of the catastrophic results he has predicted. As a result of inflation, Government indebtedness has increased considerably, but on the other hand frozen private indebtedness created through the crisis of 1931, which would otherwise have remained a permanent burden on Germany's trade, has been liquidated almost completely.

A question worth examining is: How is it that while the overvaluation of the franc crippled France economically, financially and politically, the overvaluation of the reichsmark produced no such effect in Germany? The reasons for the difference are manifold. We have already pointed out that the old parity of the reichsmark is largely fictitious, as the various blocked currencies are used for the purposes of external trade to a large degree. It is only when German goods are indispensable for foreign importers that payment in reichsmarks is necessary. In the case of competitive goods the possibility of payment in registered marks or other forms of blocked marks secures for Germany an advantage equivalent to a depreciation of 50 per cent. The same advantages are applied also to invisible exports such as tourist traffic and shipping freights. Having depreciated the international value of her currency by about 50 per cent in fact if not in law, Germany can afford to reflate internally without suffering the same consequences of international disequilibrium which affected France.

Apart from this, Germany has established an exchange control which is as near to being watertight as is possible. The overvaluation of the reichsmark cannot therefore lead to the wholesale flight of capital. Exchange restrictions have also killed speculation against the reichsmark, so that the demoralising effects of a flight from the currency and the widening discount on the forward exchange have been avoided.

Moreover, the vicious circle through which the German Government continues to recover the amount it spends, and as a result of which the budgetary deficit has not the same inflationary effect as in France, does not operate in France. Indeed, it is doubtful whether it could operate in a democratic country unless confidence in the Government's political and

financial stability were so strong as to obviate the necessity for any compulsory measures to divert the flow of funds into the proper channels.

(7) Germany's Indebtedness not Excessive

Above all, the degree of internal disequilibrium through the overvaluation of the currency is incomparably smaller in Germany than in France. Germany's public debt was virtually wiped out by the inflation of 1923, while her international debt, public and private, has been reduced to a fraction of its original amount as a result of default and the repurchase of the bonds at bankrupt prices. Thus the rise in the commodity value of the reichsmark compared with 1929 did not increase the total burden of public debt in Germany to an unbearable degree as it did in France. In itself the public debt in Germany would be no obstacle to balancing the budget, while in France the only hope for balancing the budget is through a drastic reduction of the burden of the public debt, either through drastic devaluation or through partial repudiation on the lines inaugurated by M. Laval. Owing to all these circumstances, the difficulties caused by the overvalued currency were in Germany much less pronounced than in France.

Last but by no means least, the international disequilibrium of the reichsmark has been mitigated by a system of export subsidies. This, in addition to the depreciated blocked marks, enables Germany to export in spite of the overvaluation of the reichsmark. It is true that from time to time she runs short of foreign exchange needed for the import of essential foodstuffs, but this is due to the excessive amount spent on rearmament material, as we propose to show in a later chapter. The cost of subsidies has, of course, increased the deficit, but owing to the comparatively small amount of the German public debt this burden can be borne, together with other burdens.

CHAPTER XIX

SIGNOR MUSSOLINI DROPS DEFLATIONARY POLICY

(1) The Pesaro Declaration

During the year 1935 reflation made considerable progress in Italy. In so far as this was due to the Abyssinian war and to sanctions, it will be discussed in Part IV of this book. To a large extent, however, the reversal of monetary trend in Italy was independent of political developments. Reflation would have set in even if Italy had not embarked upon the Abyssinian campaign, with all its political, economic and financial consequences, for by the end of 1934 the ruthless policy of deflation pursued by Signor Mussolini ever since 1926 had reached a stage beyond which it could not have proceeded. This was admitted to me by Signor Mussolini himself in the course of a conversation in November 1934. While he emphasised that he would be well in a position to repeat the all-round cut of wages and prices which he had enforced on two occasions, he added that "*le jeu ne vaut pas la chandelle.*"

In order to appreciate the situation in which Signor Mussolini found himself at the end of 1934 it is necessary to cast a bird's-eye glance on the developments which led to it.

On August 26, 1926, Signor Mussolini declared in a speech delivered at Pesaro, " We shall defend the lira to the last drop of our blood ". This declaration formed, for more than eight years, the basis of his whole monetary policy and to a very large extent of his whole economic policy. The immediate consequence of his statement was a sharp appreciation of the lira, which was stabilised in the following year at too high a level. The result was that Italy underwent a period of economic depression at a time when the rest of the world was enjoying prosperity. The economic depression began in Italy in 1926 instead of in 1930. As a result, in 1931, when the world as a whole found itself faced with financial crisis, Italy did not possess reserves comparable with those of other countries. Her resources had been impaired by the necessity

of struggling against the consequences of an overvalued lira. There had been big failures and expensive reconstructions in Italy already before 1931. The Bank of Italy had never been in a position to accumulate a gold reserve comparable with that of France, or even, relatively speaking, with that of Holland, Switzerland or Belgium.

(2) Why the Lira was Deliberately Overvalued

There are various theories regarding Signor Mussolini's object in deliberately overvaluing the lira in 1927. According to some, he was simply carried away by an unreasonable policy of prestige and wanted to show the world that poor Italy could stabilise her currency at a higher level than rich France. According to others, the overvaluation was a sheer blunder, due to inadequate realisation of the consequences of his act. Most people, however, are inclined to think that there was a profound motive behind his choice of the rate of stabilisation. The practical result of the overvaluation of the lira was a prolonged depression through which most banks and industrial undertakings became dependent upon Government support. The assumption is that this was exactly what Signor Mussolini had in mind. He is credited with the deliberate plan of breaking the power of banks and industrialists whose influence had remained predominant during the first few years of his régime.

His idea was, no doubt, to hold the balance between employers and employees. Whether or not his choice was deliberate, he could not have chosen a better means to that end. For, while only a few years before, Signor Toeplitz had dared to defy Signor Mussolini, by the end of 1934 the heads of the leading banks had become to all intents and purposes Government officials in charge of the commercial banking department of the State. Big industrialists with international names became little more than paid managers in their own enterprises.

(3) Signor Mussolini's Monetary Orthodoxy

All this does not, however, necessarily prove that Signor Mussolini deliberately brought about this result by means of a deflationary policy. In my opinion the explanation of the mistake made by the choice of the rate of stabilisation is much more simple. The policy pursued by Signor Mussolini between 1926 and 1934 was due simply to his orthodox outlook on monetary matters. It may appear strange that while

his economic policy is utterly heterodox he should remain entirely under the influence of ultra-orthodox monetary policy. Usually, extreme deflationism and the idol-worship of international monetary stability go together with a belief in economic *laissez-faire*. For some inscrutable reason Signor Mussolini combined a highly heterodox economic policy with a highly orthodox monetary policy. To be able to explain this inconsistency would require a much more thorough knowledge of Signor Mussolini's inner character than I possess.

If it is difficult to explain why Signor Mussolini decided to overvalue the lira in 1927, it is even more difficult to understand why, once the mistake was committed, he should have persisted in what has come to be termed " the policy of Pesaro ". The sacrifices involved in the defence of the lira at its overvalued level have kept on increasing. As we stated above, the economic depression in Italy that preceded the international economic crisis reduced the country's resisting capacity to deflation. In 1931 Italy entered the international deflation race heavily handicapped by the deflation inflicted upon her since 1926 by the policy of Pesaro.

(4) " Consistent Deflation "

Notwithstanding this, Signor Mussolini succeeded until the end of 1934 in resisting the adverse pressure on the lira. The prophets who after the suspension of the gold standard in Great Britain predicted that Italy would be among the first countries to follow her example proved to be wrong. The defence of the lira was carried on with great technical skill and with an utter disregard of the sacrifices involved. To some extent the suffering caused by deflation was mitigated by the unorthodox methods with which deflation was applied. Instead of seeking to reduce prices by the orthodox method of credit restrictions, all-round reductions were carried out on two occasions, in 1931 and in 1934, by Government decree. These decrees imposed cuts on salaries, wages, rents, prices, etc. By this method, it was possible to reduce somewhat the iniquities caused by deflationary drives.

On the surface this " consistent deflation " may appear a more drastic method than the lowering of prices by the forced liquidation of bankrupt stocks. It is undoubtedly the less popular way of deflating, since the responsibility can unmistakably be traced to the Government. But Signor Mussolini, instead of leaving the adjustment to take place in the haphazard way customary under the system of *laissez-faire*, took

the bull by the horns and enforced the less popular but more efficient and equitable method. Since wages, prices and the cost of living were adjusted downward simultaneously, the losses and inconveniences caused by the rigidity of various items and the discrepancies thus arising between them and the more elastic items were reduced. Notwithstanding this, it was impossible to get away from the inevitable adverse effects of deflation upon trade. The fall in prices created new weak positions and led to the necessity for official support for banks and industries.

(5) Public Works Curtailed

Signor Mussolini has always regarded the acquisition of majority shareholdings in banks and industrial undertakings as a necessary evil, and it has been his declared policy to resell these holdings to private investors as soon as possible. Thus the effects of deflation in this sphere were not at all in accordance with his aims. There was another reason why the acquisition of financial control over banks and industries was detrimental from the point of view of the Government's policy. The financial resources that had to be mobilised for that purpose could have been employed much more profitably in financing public works. It is easy to imagine how much more could have been achieved had the milliards required to support banks and industries against the effects of deflation been used for public works. Indeed, during 1934 the original public-works programme had to be revised owing to budgetary considerations.

A stage was reached at which Signor Mussolini was confronted with the dilemma of choosing between the speedy execution of his favourite public-works schemes and the defence of the lira through a reduction in budgetary expenditure. The increase of the budgetary deficit caused by further deflation necessitated further curtailments in the Government's programme of public works. Already the amount allocated for that purpose had had to be reduced in 1934 by about one-third. The public-works programme had been conceived with expert knowledge; its object was not merely to create additional employment in times of depression, but to make important additions of a largely productive character to the national wealth. Its drastic curtailment for budgetary considerations was therefore a loss from more than one point of view.

(6) Signor Mussolini's Attitude

There were many other arguments that could be quoted against the continuation of the deflationary policy. Signor Mussolini was aware of them; in spite of this he refused even to consider the idea of devaluation. When, in November 1934, I arrived in Rome, I was warned by my devaluationist friends that the Duce felt very strongly on the subject and hardly anybody dared even to suggest that he should reconsider his attitude. In the course of my long discussion with him on the subject, I found him much less dogmatic and more open to argument than I had been led to expect.

The opponents of devaluation were, at that time, divided into two camps. Several prominent Fascists, belonging mainly to the Right Wing of the Party, were in favour of continuing the deflationary policy. This group was headed by Signor Mussolini's ultra-orthodox Finance Minister, Signor Guido Jung. Prominent members of the Left Wing of the Party were, on the other hand, in favour of a policy of entrenchment by which Italy would maintain the commodity value of the lira at its existing level with the aid of exchange restrictions, in the hope of a rise in world prices which would restore equilibrium without a devaluation of the lira. This latter view was strongly held by Signor di Stefani, among others.

At first it appeared as though the deflationists would win. In November the Italian bank rate was raised and it seemed as if future deflation would be effected by orthodox methods instead of by Signor Mussolini's unorthodox "consistent deflation" of all-round cuts. Before long, however, Signor Mussolini decided to reject the idea of further deflation. By "sacking" virtually the whole Cabinet overnight he removed Signor Jung from the Finance Ministry and replaced him by the more progressive Signor Thaon de Revel. This did not, however, mean that he was ready for devaluation. Notwithstanding the overwhelming arguments in its favour, he still hesitated to adopt that solution. In the course of my conversation with him in November 1934, I did my utmost to draw his attention to these arguments. He appeared to have been already aware of many of them and appeared to appreciate the new points to which I drew his attention. He was unable, however, to make up his mind to take the fateful decision. Like so many other statesmen before and after him, he imagined that devaluation would be politically unpopular and would weaken his régime. Instead of resorting to a clear-cut

solution he aimed at achieving the same end by less conspicuous changes.

(7) Gradual Depreciation of the Lira

In the first place drastic exchange restrictions were adopted, and by this action Italy virtually ceased to be a member of the Gold Bloc, even though the lira was within reasonable distance of its gold parity. Apart from measures aiming at the prevention of the outflow of capital, provisions were made for the compulsory declaration of privately owned foreign assets, which were to be held henceforth at the disposal of the authorities. At the same time the lira was allowed gradually to depreciate. Its value was reduced in hardly perceptible stages, and its decline was from time to time interrupted by temporary recoveries. Nevertheless, by the middle of the year the lira was at a discount of about 8 per cent against the franc. This was certainly a new method of departing from gold. If it was true that Great Britain was swept off the gold standard and that the United States deliberately walked off the gold standard, it is equally true that in 1935 Italy was crawling off the gold standard.

Needless to say, a depreciation by 8 per cent was far from sufficient to restore the lira to equilibrium. Nor did it produce the psychological effect that would have accompanied a straightforward devaluation. Everybody was inclined to assume that the process of deflation would continue, so that the atmosphere of tension and uncertainty continued to prevail. To some extent trade benefited by the rising tendency of prices, brought about not so much by the relatively moderate depreciation of the lira as by the increased industrial activity in connection with the preparation for the Abyssinian war. On the whole, however, it may be said that during the first half of 1935 Italy got the worst of both worlds. She had no longer the moral satisfaction—for what it is worth—of maintaining a currency at its old parity, nor the psychological and material advantages of a devalued currency.

PART IV
SANCTIONIST INTERLUDE

CHAPTER XX

FROM PESARO TO ADDIS ABABA

(1) Italy Abandons the Gold Bloc

In Chapter XIX we described the developments which led to the abandonment of the deflationary monetary policy in Italy. The policy adopted was to allow the lira to depreciate gradually and as imperceptibly as possible to a relatively moderate degree without officially recognising its depreciation. Presumably what Signor Mussolini had in mind was that, should the much-expected rise in world prices materialise, it would be possible to restore the lira to its old level and maintain it there without undue difficulty. Meanwhile, the Italian authorities sought to ease the situation by the moderate depreciation of the lira and by exchange restrictions.

The depreciation of the lira was so gradual that it was difficult to say at which particular moment Italy actually abandoned the Gold Bloc. After all, ever since 1931 the lira had been constantly rather under gold export point, and it had been the declared policy of the Italian authorities to keep it there in order to discourage bear speculation by means of inflicting losses upon them through squeezing. The discount on the lira over the franc varied during the period 1931 to 1934 between 1 per cent and 3 per cent. When early in 1935 its depreciation gradually assumed wider dimensions, it became evident that the discount could hardly be claimed as a mere technical arrangement, and that it constituted a marked departure from the old parity.

(2) Letter and Spirit of the Pesaro Promise

How could this state of affairs be reconciled with the Pesaro promise? The Italian authorities got over this difficulty simply by forbidding the Press to comment on it. The official exchange rates were quoted and leading politicians, economists and journalists continued to pay lip-service to the Government's determination to defend the lira. In reality, on the basis of the interpretation of the Pesaro promise which was current in Italy, a departure from the old parity by

8 per cent was as much contrary to its terms as a departure by 40 per cent. As I pointed out at the time, in the course of a series of articles on Italy in *The Financial News*, a departure from the old parity was by no means incompatible with the letter or the spirit of the promise made by Signor Mussolini in 1926. At the time when he pledged his word to defend the lira, the sterling–lira rate was at 158, and so long as it was below that figure Signor Mussolini had every right to claim that it was in accordance with the letter of his promise. Towards the end of 1934 the sterling–lira rate was at 58. Even if the gold value of the lira in August 1926 is taken as the basis of the literal interpretation of the Pesaro statement, there was still ample scope for depreciation in 1934–5, without coming into conflict with the letter of that promise. From the point of view of the spirit of Signor Mussolini's undertaking, neither the gold value nor the sterling value of the lira mattered, but its internal purchasing power, as expressed by the index number of wholesale prices. In August 1926 that index number was over 700, while the average for 1934 was 275. Thus in order to adhere to the spirit of the Pesaro statement it would have been sufficient to avoid a depreciation of the lira which would have raised wholesale prices to above their 1926 level. After all, from the point of view of the predominant majority of Italians it was the cost of living that mattered. Signor Mussolini never promised at Pesaro to bring about an appreciation of the lira, either in terms of gold and exchanges or in terms of goods and services. From the point of view of the spirit of the Pesaro statement it would have been satisfactory if the internal value of the lira had been allowed to go back to its August 1926 level, but not beneath that level. The increase of its internal value was an act of grace in addition to what Signor Mussolini had undertaken, and nobody could reasonably have blamed him if, under the force of circumstances, he had decided to keep his promise, but no more than his promise.

Evidently this is the common-sense interpretation of the Pesaro statement, and when I put it to Signor Mussolini in November 1934 he did not show himself averse to it. Nevertheless, his subsequent actions indicated that he continued to interpret his Pesaro promise as an undertaking to maintain the lira at the gold value to which it was raised after Pesaro and at which it was stabilised in 1927. While he agreed to a gradual and moderate depreciation, it is reasonable to assume that he had in mind a return to the old parity at the earliest

opportunity, and that he was led to believe that an early rise in the world's price level would provide that opportunity.

(3) The Deadlock in 1935

By the middle of 1935 it was amply evident that the much expected spectacular rise in world prices was not forthcoming. In my opinion, even if it had materialised it would not have helped Italy to any considerable degree, since for a long time it would have been confined to raw material and food prices, while manufacture prices would have risen very slowly. As a result, Italy would have had to pay more for her imports and her manufacturers would not have been in a much better position than their foreign rivals. This is, however, beside the point. What matters is that, by the summer of 1935, hopes for an early restoration of the lira to its old parity had to be abandoned. In the absence of a rise in world prices, its restoration would inevitably have produced a deflationary effect, and as we have seen in Chapter XIX, Signor Mussolini abandoned deflation early in 1935.

The situation was, therefore, that the lira had deserted its old parity and there was very little hope that it could recover within a reasonable space of time. On the basis of the official interpretation of the Pesaro promise, this was a humiliating situation. Rightly or wrongly, Signor Mussolini and his advisers imagined that it was likely to be detrimental to his personal prestige and to the prestige of the régime, especially as the country did not derive any noteworthy economic benefits from the moderate depreciation of the lira. Trade remained on the whole depressed, and unemployment remained high.

(4) Effect on Abyssinian Scheme

It may have appeared desirable, from the point of view of the prestige and popularity of Signor Mussolini and Fascism before Italian public opinion, to embark upon an action which was calculated to divert attention from the depreciation of the lira and which might produce results calculated to restore the prestige and popularity thus lost. It was repeatedly stated by various students of the Italian situation in 1935 that the main object of the Abyssinian adventure was to divert attention from the internal economic and financial situation of Italy. Although in this form the view may be one-sided and exaggerated, there can be little doubt that it contains at least part of the truth.

A major military undertaking was certainly very suitable for diverting attention from the depreciation of the lira. It was also calculated to mitigate the trade depression and at the same time to divert attention from it. It was reasonable to assume that the bulletins from Abyssinia would overshadow in importance exchange rates and unemployment returns. Moreover, a colonial campaign undertaken by an army running into hundreds of thousands would provide a legitimate excuse—if indeed an excuse was needed—for departing from a monetary policy undertaken in time of peace. After all, the victorious pursuit of any war is the primary consideration compared with which monetary policy disappears into insignificance. Moreover, the success of acquiring important colonial possessions was reasonably expected to strengthen Signor Mussolini's prestige in Italy to a considerable degree, and with his prestige strengthened he would be in a position to devalue openly without having to fear its repercussions upon the popularity of his régime.

(5) Raw Material Problem

The overvaluation of a currency in general tends to make for aggressive foreign policy on the part of nations without adequate raw material resources of their own. The increasing difficulties of export by countries with overvalued currencies aggravate the problem of providing exchange for imports of essential food and raw materials and give rise to endeavours to obtain possession of raw material and food resources, if necessary by means of conquest. The example of Italy is highly suitable for confirming this rule. In the case of Italy there was, however, in addition to the difficulties caused by a deflationary policy in defence of an overvalued currency, also the special difficulty caused by the Pesaro promise. This, combined with the difficulty of securing essential imports, had a large share in the responsibility for launching out the Abyssinian campaign. Admittedly, considerations of political prestige also played an important part. Having reorganised his country, Signor Mussolini set himself the task of building a colonial empire for the greater glory of his régime. It is doubtful, however, whether this consideration in itself would have been sufficient to lead to the Abyssinian conflict and to induce Italy to defy the League of Nations. An economic factor played an important part in shaping Italy's foreign policy in 1935. This economic factor had arisen for the most part through Signor Mussolini's refusal to modify in practice

his interpretation of his Pesaro promise. It was his Pesaro statement that eventually sent the Italian armies to East Africa. In 1926 few people would have realised that the road embarked upon at Pesaro was to lead to Addis Ababa ten years later.

Admittedly, from a purely Italian point of view the fact that the deflationary monetary policy initiated at Pesaro led to the conquest of a Colonial empire may be regarded as an argument for and not against deflation. This is, however, essentially a short-sighted view, for the Abyssinian campaign led to the breaking up of the Stresa front, which was the only possible safeguard of European peace. It gave Hitler his chance to reoccupy the Rhineland, to detach from France some of her allies, and to strengthen his influence in Austria and Hungary. It is to be feared that sooner or later the Abyssinian conflict, which originated in the Pesaro policy, will bear its fruit in the form of a European war. The result can be nothing else but destruction for victor and vanquished alike. Those in Italy who survive the disaster will then have every reason to realise that the Pesaro policy spelt disaster for Italy in spite of the passing glory of the Abyssinian conquest.

CHAPTER XXI

THE TRAGI-COMEDY OF SANCTIONS

(1) Irresponsible Statesmanship

In 1935 the world was struggling with the major economic problem of recovering from the prolonged depression; with the major financial problem of restoring internal and international equilibria of currencies; with the major commercial problem of carrying on international trade amidst growing difficulties; and with the major political problem of meeting the growing danger to world peace of German rearmament. Each one of these problems would have been ample to tax to the utmost the capacity of political and economic statesmanship. And yet the world's statesmen thought they could afford to add deliberately a few more problems and to complicate further the existing ones. The policy of economic and financial sanctions adopted by 52 nations against Italy was, it is true, provoked by the latter's act of aggression against a fellow-member of the League, but two blacks do not make a white. The adoption of sanctions, which were obviously foredoomed to failure, only proved that reckless irresponsibility is not the exclusive monopoly of dictatorship.

Following upon Italy's attack on Abyssinia in October 1935, 52 members of the League of Nations passed a series of resolutions for the application of economic and financial measures by which they hoped to compel Italy to abandon her intention of conquering Abyssinia. The States that adhered to these measures had undertaken not to grant any loans or credits to Italy; not to export to Italy certain commodities which might be useful for the pursuit of war; and, above all, to refuse to buy Italy's goods. The third of these measures was by far the most important.

(2) Financial Sanctions and Embargo on Exports

As far as financial sanctions are concerned, even in the absence of any special agreement to that end it would have been impossible for Italy to borrow abroad while she was at war with Abyssinia and while there was considerable danger

of her being involved in a European war. Indeed, British and American bankers called in their credits to Italy about two months before the beginning of the Abyssinian war and about three months before the application of financial sanctions, which in any case were never applied by the United States. The commercial firms engaged in trade with Italy also adopted the rule of trading on a strictly cash basis long before their respective Governments had laws passed to that effect. From this point of view the application of financial sanctions merely confirmed the existing state of affairs.

The prohibition of the sale of certain materials and manufactures to Italy was also relatively unimportant as a measure to force Italy to change her policy. For one thing, the most important material, oil, a supply of which was indispensable for the pursuit of the war, was never included. Indeed, in compiling the list of goods subject to sanctions, the committees and sub-committees at Geneva witnessed some remarkable haggling. Each Government was anxious to include in the list the exports of other countries. The story goes that the Turkish delegate, having voted with enthusiasm in favour of the prohibition of the export to Italy of aeroplanes and the like, objected to an embargo on coal exports. "My Government cannot agree to that," he said, "because, you see, we do export coal to Italy." Other delegates were less delightfully candid but acted more or less in the same spirit. Moreover, the Governments were careful to include only commodities which Italy could afford to dispense with for the conduct of war. They were anxious to avoid driving Signor Mussolini into despair by imposing sanctions of a kind which might prove effective. There was in any case hardly a commodity necessary for military purposes which Italy could not obtain from non-sanctionist countries.

(3) Embargo on Imports from Italy

The prohibition of certain exports to Italy was never meant to be much more than a gesture. The sanctionist statesmen and their economic and financial advisers built all their hopes upon the third group of measures, which aimed at a complete embargo on imports from Italy. Their reasoning was simple. Indeed, it was much too simple. They thought all they had to do was to refuse to buy from Italy, and since Italy would have to continue to import, not being self-sufficient, the absence of any possibility of export would sooner or later deplete her gold resources. Once these resources were ex-

hausted, Italy would no longer be in a position to buy materials for war requirements abroad. Thus the embargo on exports of war materials to Italy would become effective through the embargo on imports from Italy. This ingenious scheme was endorsed by some of the leading economists in Great Britain and elsewhere. It is therefore no wonder that illiterate politicians were prepared to stake everything on it.

And yet they received a timely warning of the difficulties of enforcing an all-round embargo on imports from Italy. A committee of experts, on which the British Government was represented by Mr. Hawtrey, elaborated a report in June 1935 disclosing frankly all the difficulties. Its findings received, however, practically no publicity, for by that time it was already becoming fashionable on the part of the newspapers to outbid each other in their sanctionist zeal and optimism.

There are innumerable reasons why the policy aiming at the depletion of Italy's gold resources through an embargo on the import of Italian goods was doomed to failure. The following are some of the most important and most obvious among them.

(4) Boycott of Italian Goods not Universal

(1) There was never the least hope that the embargo would become universally adopted. Important countries such as the United States, Japan, Germany and several Latin-American republics were outside the League and their attitude never encouraged hopes that they would join in the boycott of Italian goods. Nor was it to be expected that all members of the League would adhere to the boycott. Some of them —Austria, Hungary and Switzerland—openly declared their unwillingness to apply sanctions against Italian goods. Others signed the Convention, but only in order to derive substantial benefit from disregarding it. Trade across the Yugoslav–Italian frontier, for instance, remained as brisk as ever throughout the period of sanctions. Poland, Czechoslovakia and other countries also increased their sales to Italy, and there was evidence to show that a great part, at any rate, of their exports was paid for in the form of Italian goods or tourist coupons. To quote these examples in support of the assertion that sanctions were foredoomed to failure cannot be dismissed as being wise after the event. Any student of politics, of the economic situation and especially of human nature, ought to have foreseen that a number of countries would violate the letter and the spirit of the embargo. Some of

the States would seek to hunt with the hounds by signing the agreement and to run with the hare by violating it. The temptation to increase exports after six lean years of trade depression was bound to be too strong to resist. And the fact that there was little chance of materially increasing exports unless payment for at least part of them was accepted in the form of Italian goods or services was bound to constitute another loophole in the sanctionist system.

(5) Italy's Forced Exports and Reduced Imports

(2) It was to be foreseen that Italy would do her utmost to increase the sales of her goods in those markets which were not closed to her. In order to procure exchange, she was in a position to subsidise her import trade until exporters were able to quote low enough prices to tempt importers in sanctionist and non-sanctionist countries alike to buy Italian goods. Partly by this means and partly by the application of the principle of bilateralism, Italy was bound to be able to retain a fair percentage of her former export trade.

(3) At the same time, the Italian Government was in a position to cut down to a minimum all imports for the requirements of the civilian population. It was possible in a disciplined Fascist state to establish industries almost overnight and to compel consumers to take substitutes. It was equally possible to induce the public to put up with inconveniences and to deprive itself of many luxuries and even of some necessities for the sake of securing victory. The example of Germany between 1914 and 1918 should have been sufficient to make the statesmen of 1935 realise that a nation which is at war is prepared to make sacrifices in the interests of victory. It was evidently possible for the Italian Government to reduce civilian imports to an extent which would more than offset the increase of military imports.

(4) Nor was there any reason to suppose that imports for the requirements of the Abyssinian war would be exorbitant enough to deplete the gold resources of Italy in a short time. After all, the Abyssinian war was only a colonial campaign in which only a fraction of Italy's human and material resources was engaged. A very large proportion of its supplies did not necessitate any spending of foreign exchange. It is true that throughout the period that preceded the application of sanctions, and to some extent even during their application, the Italian Government bought large amounts of metals and other raw materials necessary for war purposes. These imports

could not, however, be regarded in the same light as the current requirements of the Abyssinian campaign. The materials were required to constitute a reserve supply. From a financial point of view, all that happened was that part of the gold reserve was converted into copper reserves, oil reserves, coal reserves, etc. It did not in any way diminish Italy's resisting capacity to sanctions. It was reasonable to assume that by cutting down imports for civilian requirements and by pushing exports to the utmost, the Italian Government would be able to reduce the trade deficit to a relatively moderate figure, and that in consequence it would take a long series of years before that trade deficit would lead to the depletion of the gold reserves.

(6) Italy's Gold Resources

(5) The amount of these gold reserves themselves should have been viewed with less optimism by sanctionists. It is true that in the course of 1934 and 1935 the Bank of Italy lost a considerable proportion of her gold reserve. The counterpart of this loss was represented, however, by Italian private holdings of foreign assets. Even though it was impossible to seize many of these assets, the amount the Government was able to lay hands upon cannot have been negligible, considering that in a Fascist state there are special means at the disposal of the authorities to compel the surrender of such assets. It was equally evident that the Government was in a position to collect a considerable amount of gold from private possession. Finally, even though it would have been the height of folly to part with historical relics and art treasures, if the worst came to the worst the Government would probably have found buyers for some of them in the United States and elsewhere.

(6) It should therefore have been evident that the exhaustion of the Italian gold reserve through sanctions was not a matter of a few months but of many years. But even on the assumption that all the above arguments are false and that there was a chance of depleting the gold reserve within a few months, sanctions on Italian exports were futile. I wonder if any of the sanctionist economists, politicians and publicists have ever asked themselves the question, what would have happened if Italy's gold reserve had become depleted? The reason why Geneva did not dare to risk imposing oil sanctions on Italy was the fear that, driven to despair, Signor Mussolini might decide in favour of a European conflagration

rather than submit to humiliating defeat for lack of oil. As a matter of common sense, it may well be asked what the difference would have been from this point of view whether Signor Mussolini was threatened with deprivation of his oil supply owing to an embargo on oil exports to Italy or owing to an embargo on Italian exports. The very success of an embargo on Italian exports would have defeated its object, for a point would have been reached when it would have implied the risk of a European war. The sanctionist nations would have had to relinquish their weapon of coercion just when it was beginning to have its effect, in order to avoid the risk of a war. There was no need to possess any supernatural prophetic faculties to foresee this. Indeed, it required an exceptional degree of fanaticism and blindness to overlook it. The experience of the period of sanctions provided ample confirmation of most of the points raised above.

(7) Sanctions "Leaking like a Sieve"

Above all, throughout the period sanctions were leaking like a sieve. Great Britain was probably the only country which meant to enforce them conscientiously, and even here Italian goods were not altogether unobtainable. There was no difficulty in obtaining gorgonzola from the leading grocers, because if an Italian cheese was ripened in Switzerland it did not come under sanctions. "Austrian" furniture of evidently Italian make was obtainable at ridiculously low prices at some of the leading London stores. A Swiss chocolate manufacturing firm willingly lent its name and its wrappers to Italian-made "peruginas". Such examples could be multiplied. And yet the British authorities did their utmost to make sanctions effective. This is more than the authorities of other "sanctionist" countries could claim.

If a French customs official was told that certain goods came from Yugoslavia via Italy, he was only too willing to take the importer's word for it, even though French customs officials are not exactly reputed for their credulity, and even though it required very little general knowledge to know that Yugoslavia never produced goods of that kind. Admittedly, if we inspect the French customs returns we see very little evidence of imports from Italy during the period of sanctions. But then, one of the lasting consequences of sanctions was that they played havoc with the trade returns of 51 countries out of 52 as far as trade with Italy was concerned. Czechoslovakia, anxious to capture the Italian market formerly held

by the South Wales coal producers, was only too willing to accept tourist coupons in payment for coal, with the result that during the year of sanctions Italian hotels were full of Czechoslovakian tourists. Admittedly, this arrangement did not violate the actual letter of the sanctions impositions to which Dr. Beneš, one of the mainstays of the League, adhered with enthusiasm. The sanctionist statesmen simply overlooked the fact that Italy could export services as well as goods, and confined the boycott to Italian goods.

(8) "Sanctionist" Yugoslavia

The description of the attitude of Yugoslavia towards sanctions would require a chapter to itself. During the first half of 1935 Yugoslavia was still suffering from acute depression. Towards the end of that year and the beginning of 1936 there was evidence of a degree of prosperity comparable with that of pre-slump days. Admittedly, Yugoslavia had no reason for liking Italy; indeed, until the beginning of the Abyssinian campaign it was feared in Belgrade that Signor Mussolini would deliver his first blow at Italy's neighbour across the Adriatic. In face of business prospects, however, political antipathy vanished. In all fairness to Yugoslavia it must be admitted that, having adhered to sanctions, she refused to buy Italian goods—unless they were ever so much cheaper than other goods which she had to import in any case. She also refused to supply Italy with goods that came under the embargo on exports—unless Italy was prepared to pay a really tempting price for them.

Yugoslavia was gaining both on the swings and on the roundabouts. This did not prevent her, however, from being the loudest in the chorus of those who lamented the sacrifices they had made in the interests of international peace, and who demanded compensation for those sacrifices from Great Britain. The Yugoslav Government actually succeeded in obtaining certain concessions in favour of exports of Yugoslav poultry and other articles to Great Britain. These concessions managed somehow to survive sanctions, and were actually in existence when Yugoslavia, yielding to Dr. Schacht's overtures, sold her body and soul to Hitler and adopted a policy penalising British exports in favour of German exports.

And it is for the sake of such a farce that sanctionist statesmen have thought it wise to antagonise Italy and drive Signor Mussolini into Hitler's arms.

CHAPTER XXII

THE ECONOMIC CONSEQUENCES OF SANCTIONS

(1) Sanctionist Statesmen's Optimism

What were the actual results of the application of economic and financial sanctions? They certainly did not prevent Marshal Badoglio from conquering Addis Ababa within a few months. In face of this inescapable fact, sanctionists seeking to whitewash their policy would like to make us believe that, had the war not come to such a swift conclusion, the sanctions would have achieved their end. These statesmen were astonished when the Italian army accomplished in a few months the task which they had expected would take many years. And yet, was it really so unexpected? The excuse that it was merely the result of the ruthless use of poison gas by the Italian Air Force is not particularly impressive, for did any of these statesmen who were so loud in denouncing Signor Mussolini's ruthlessness doubt for a moment that if necessary he would be quite capable of resorting to the use of gas? Admittedly it involved the breaking of a pledge, but then, having broken the Covenant, the Kellogg Pact and the Abyssinian treaties, the breaking of yet another undertaking could hardly have appeared to be out of the question, and should not have been left out of the reckoning when measures were decided upon which were not expected to bear their fruit until 1937 or 1938.

Apart altogether from the swiftness of Marshal Badoglio's victory, there was no reason to expect sanctions to become really effective, even if the Abyssinian campaign had taken years instead of months. In this respect the optimism of sanctionist statesmen was unpardonable. In the absence of any adequate figures, they took it for granted that sanctions were highly effective and that the Italian gold reserve was rapidly becoming depleted. Indeed, a British statesman went so far as to state in public in January 1936 that Italy's gold resources were virtually depleted, presumably much to the surprise and amusement of those quarters in Rome who knew better.

Abyssinian war and its consequences must have been relatively moderate. They were covered largely out of the Government's gold stock, obtained through the surrender of wedding rings and other gold objects, and through the surrender of privately-owned foreign assets. Even that gold stock has not been exhausted, and its balance is being used as the working funds of the Italian equivalent of our Exchange Equalisation Account.

(2) Prophecies of "Collapse"

Those who hoped to be able, with the aid of financial and economic sanctions, to force Italy to abandon her Abyssinian campaign, expected that the sanctions would produce a twofold financial effect. In the first place they would gradually deplete Italy's gold resources and would deprive her of the means by which to import indispensable raw materials for the purpose of the war. Apart from this, it was expected that sanctions would lead to wholesale inflation, culminating in a general collapse. Those who prophesied this collapse in the case of Italy, and those who had even expected it in Germany every day since the advent of Hitler, never took the trouble to define exactly what they meant by collapse. Presumably what they had in mind was such an advanced degree of inflation as various Central European countries witnessed after the war, leading to a complete depreciation of the national currency in terms of internal purchasing power.

We saw in Chapter XVIII that in Germany there has been no danger of such developments, in spite of the gigantic public expenditure undertaken for rearmament and public works. In face of the German experience of 1933–5, was it reasonable to assume that Italy would experience such a disastrous collapse? After all, while Germany had practically no gold reserve, Italy had succeeded in retaining a reasonable amount of gold. Both Italy and Germany had to subsidise exports in order to procure exchange for imports, but the budgetary

burden represented by the subsidies was in both instances insignificant compared with the amount spent on public works and rearmament. In Italy, as in Germany, the Government was in a position to finance its deficit by making use of the resources of banks, savings banks and insurance companies, and by limiting the dividends payable by joint-stock companies and compelling them to reinvest the surplus in Government securities. Admittedly, Signor Mussolini was less fortunate than Hitler in that he had not the services of a financial genius such as Dr. Schacht at his disposal. But since he himself had acquired a knowledge of finance far superior to that of his German colleague, Italy's disadvantage was not too great from this point of view.

(3) Rising Prices and the Lira

The rise in commodity prices and in the cost of living which took place in Italy during the last quarter of 1935 and during 1936 was due not so much to the budgetary deficit as to the direct effect of sanctions, which resulted in a scarcity of various commodities, and which led to the production in Italy of commodities which were formerly imported, at a much higher cost. The rise in commodity prices was, however, relatively moderate, and the process could hardly be regarded as uncontrolled inflation. In any case, owing to the heavy burden of Italian public debt, the rise in commodity prices was a blessing in disguise, in that it tended to reduce the burden of deadweight indebtedness in terms of commodities.

Notwithstanding the rise in prices, the lira was maintained more or less at the level to which it had depreciated prior to the Abyssinian campaign. Its quotation was, needless to say, nominal, as dealings in lire were virtually suspended. There was, of course, a black market at which rates fluctuated widely and at which the lira at times registered depreciations of between 30 and 40 per cent compared with its gold parity. There was also the tourist lira, which was adopted to attract foreign visitors, in spite of the atmosphere of tension which was caused by war and sanctions and in spite of the high prices prevailing in Italy. Thus the official lira rate, which itself was a depreciated rate, was to a large degree fictitious. The suspension of dealings in lire facilitated the maintenance of this artificial rate and increased the difficulty of exporting capital to Italy. The absorbing capacity of the black market was never large, and the export of capital through smuggling lira notes across the frontier was relatively

moderate, especially as the re-import of the exported notes was prohibited. The Exchange Control was becoming increasingly efficient, so that apart from the trade deficit the exchange problem in Italy was not by any means very great.

Doubtless the civilian population suffered a great deal through sanctions, in that it was difficult to obtain coal for household purposes, and there was a shortage also of other necessities. The hope that these inconveniences would turn the public against the Government did not, however, materialise. It was not Signor Mussolini who became the subject of hatred, but the sanctionist powers. The inconveniences caused by sanctions to the civilian population did not in the least interfere with the pursuit of the Abyssinian campaign.

(4) A Blessing in Disguise

Let us now cast a glance upon the other side of the picture. It has always been Signor Mussolini's desire to make Italy as self-sufficient as possible. To that end, large areas of marshes had been reclaimed at high cost, and the fertility of arable land had been increased. Nevertheless, the balance of visible trade had always been adverse. The surplus of imports had always been paid for partly by the Italian emigrants' remittances and partly by the spendings of foreign tourists. The former source dried up as a result of the prolonged depression in the United States and South America and also in consequence of the pessimism regarding the prospects of the lira. The tourist spendings had also declined considerably even before the Abyssinian war. It became desirable for Italy to cut down her imports to the level of her exports if she was unable to raise the volume of her exports. The difficulty was, however, that the establishment of new industries which would have enabled Italy to dispense with part of her imports would have necessitated the denunciation of her trade agreements with a number of countries, and this in turn would have hit Italian exporters hard.

Thanks to Mr. Eden and to economic sanctions, Signor Mussolini was able to solve his problem to his satisfaction. As the sanctionist countries stopped buying from Italy, the Government encouraged the establishment of industries to produce goods which had formerly been imported from those countries. From the point of view of the policy of self-sufficiency, sanctions were indeed a blessing in disguise. In normal conditions it would have taken decades to make the same progress towards national self-sufficiency which was

made in a few months as a result of sanctions. Once the new industries were established they could depend upon being protected against foreign competition even after the removal of sanctions. Economic nationalism in Italy received a powerful stimulus through the sanctionist policy of the League powers.

(5) British Trade's Losses

The effect of sanctions outside Italy is also worth some attention. It was inevitable that they should inflict some losses upon exporters to Italy and importers from Italy. Fortunately, in 1935 the trend of world prices was already distinctly in the upward direction, and the dislocations and losses caused by sanctions were unable to check the recovery. This was, however, small comfort for individual firms and branches of industries which had to bear the burden of sanctions. Needless to say, British trade was the chief victim. Every sanctionist country would have liked to present the bill to Great Britain, and in the case of Yugoslavia the Government was, in fact, prepared to make certain concessions in compensation for non-existent damages. Coal exporters of South Wales, and other British traders hit by the sanctions, received no such generous treatment. They simply had to stand the loss inflicted upon them by the action of their own Government.

Apart from the loss of an important market, British trade was penalised also as a result of the freezing of Italian commercial debts. While the Italian Government provided the exchange for the repayment of banking claims against Italy, it refused to help in any way to clear the overdue commercial claims. The majority of these claims were represented by the accumulation of balances on the voluntary clearing agreement operating between Great Britain and Italy since the spring of 1935. Since the payment for goods imported from Italy into the clearing account was not compulsory, there was wholesale evasion of the arrangement; hence the big credit balances. The Government was frequently urged to make the clearing compulsory so as to be able to collect the funds to meet the claims of British exporters, but refused to do so until sanctions began to operate. The clearing was made compulsory in November 1935, when it was no longer possible to import goods from Italy. On the other hand, it served a useful purpose in collecting at least some of the outstanding debts owed by British importers of Italian goods.

The amount collected would have been much larger had the Italian authorities been willing to supply the British authorities with the list of the British debtors. As a measure of counter-sanctions they refused, however, to do so, and consequently it was impossible to collect the bulk of the outstanding amount. The Government in this instance was doubly responsible for the inconvenience caused to British trade, not only through imposing on Italy futile sanctions but also owing to its refusal to make the clearing compulsory until it was too late. Nevertheless, no compensation was forthcoming to the British victims of sanctions.

Even when after the conquest of Addis Ababa the utter futility of sanctionist policy became evident, there was strong opposition to their removal, and Great Britain maintained them until the middle of July 1936. Other countries removed sanctions, in fact or in law, much earlier, and this further weakened the chances of British trade for recovering its Italian markets. To a very large extent the loss of these markets to British trade may be regarded as permanent, not only because of the establishment of Italian national industries, but also as a result of the success of other countries in establishing themselves in the Italian market in place of their British competitors. Thus sanctions were not only unable to achieve their end, but they proved to be distinctly harmful to the one country which applied them conscientiously.

PART V

THE BATTLE OF THE FRANC

CHAPTER XXIII

BOLSTERING UP THE FRANC

(1) General Public Exports Capital

M. Laval's resignation in January brought about another spell of flight from the franc. With the establishment of the stop-gap Government under M. Sarraut, which was to carry on until the General Election, the attack on the franc subsided after the new Government had made reassuring statements about its intention to defend the currency. This time the run was not very heavy. There was no need even to raise the bank rate, which was lowered from 6 per cent to 5 per cent at the end of 1935 and to 3½ per cent between December and the beginning of February. The amount of gold lost during January was barely more than one milliard francs, which, compared with the huge losses suffered on the two previous occasions, was indeed moderate.

French anti-devaluationist experts triumphantly pointed out that the smallness of the losses in January was an indication of the scarcity of funds available for withdrawal abroad. Indeed, it was true that the big companies and wealthy industrialists exported during 1935 about as much capital as they could possibly export without exposing themselves to scarcity of funds at home. Their bankers were none too willing to extend credit facilities, so that from time to time they even had to liquidate some of their foreign assets in order to meet urgent domestic requirements. The general public, on the other hand, had not yet acquired the taste for capital export to any noteworthy extent.

(2) Resources Available for Exporting Capital

Ever since the beginning of the crisis in 1931 distrust in the banks had led to the wholesale hoarding of franc notes. The amount of hoarded notes was estimated at various times by various authorities as being between 20 and 35 milliard francs. This in itself was an almost inexhaustible source of funds available for the purchase of gold or foreign currencies. In addition, the total deposits in French commercial banks were

still some 27½ milliards at the beginning of 1936. Admittedly a large part of this amount constituted the working capital of French industrial and commercial undertakings, and at such was not available for export. Moreover, had deposits been withdrawn from commercial banks on a large scale, it might have led to some contractions of credit, and the debtors might have had to repatriate some of their capital. There was, however, in addition to the commercial bank deposits, a large amount of savings bank deposits. At the beginning of 1936 the deposits in French savings banks, including the Post Office Savings Bank, amounted to 63 milliard francs.

Allowing for the hoarded notes and for the part of commercial banks' deposits which was available for transfer abroad, it was safe to assume that the total funds available for conversion into gold or foreign exchange was more than 100 milliard francs. There was also a huge amount of Government and other fixed interest-bearing securities held by the public. Their owners could have raised funds for export by selling their securities in the Bourse. It is true that the absorbing capacity of the Bourse was not very large and heavy selling would have brought down quotations to a level at which it no longer appeared profitable to sell in order to escape devaluation. Even so, an uncertain but by no means negligible amount has to be allowed for marketable securities when estimating the total available at the beginning of 1936 for the purpose of conversion into gold and foreign exchange.

Against this, the Bank of France's gold reserve amounted to 65 milliards only. There was therefore no justification whatsoever for the optimism which prevailed in quarters closely connected with the Bank of France that the resources available for being exported abroad would become exhausted long before the Bank of France's gold reserve had declined to the legal minimum. Even if allowance was made for the fact that the bulk of these funds would not be exported, the export of only one-third of the amount available would have been ample to bring the gold reserve below the statutory minimum of 35 per cent, all the more so since the export of capital would inevitably have necessitated an expansion of credit. As far as savings banks' deposits are concerned they are entrusted to the *Caisse de Dépôts et de Consignations*, which again employs its total resources in Government funds. Heavy withdrawals would have necessitated for this institution the reduction of its holdings, and since the depreciation of long-term loans would have made it difficult to liquidate these investments

without cutting heavy losses, the *Caisse* would have had to endeavour to reduce its Treasury bill holdings. This, of course, would have meant that the Bank of France would have had to take over what the *Caisse* was no longer in a position to carry.

(3) Hoarding of Foreign Notes and Gold Coins

The vital question was, to what extent would the small man follow the example of his richer fellow-citizens? Ever since 1931 there had been a certain amount of hoarding by small people, as was indicated by the premium paid on gold coins, a premium which increased considerably in the provinces. There was also, during periods of political and financial uncertainty, a very widespread practice of dividing gold bars among people who could not afford to hoard a whole bar. A certain amount of demand for foreign notes, especially for pound and dollar notes, became evident. Needless to say, small people were not in a position to open accounts abroad, but they had these various other means at their disposal for hedging against devaluation.

During the second half of 1935 there was, in fact, much evidence to show that retail hoarding was on the increase. A remarkable increase of the Bank of England's note circulation was in itself an indication of this tendency. During the earlier stages of this increase it was attributed to the trade revival, but to experts this explanation sounded unconvincing, since the extent to which the note circulation declined during the worst slump in trade was negligible compared with the pace at which it increased during 1935. In banking circles it was well known that large amounts of notes were taken for France and were retained there. At the same time a large amount of sovereigns and other coins was shipped from London to France by bullion brokers and banks who had accumulated them from internal circulation or who had bought them from London gold deposits. The fact that it was worth while to send the sovereigns across to France, in spite of the premium they commanded in the London market compared with their bullion value, showed that there must have been a keen demand for gold coins on the part of French small hoarders. It is safe to assume that the demand for dollar notes and for eagles was at least as keen as for pound notes and sovereigns. There was thus ample evidence to show that the small man in France had also resorted, to an increasing extent, to hedging against devaluation.

(4) Bank of France demands Further Deflation

In face of this evidence, what was the attitude of the Bank of France? The only word of wisdom the Government of M. Sarraut got from that quarter was the parrot-like repetition of the demand for more economies. As their favourite, M. Laval, had departed, they made an attempt to reassert their controlling position in relation to the new Government. Since the Treasury was by then completely converted to devaluation, relations between the two branches of monetary authority became very strained. The fact that M. Monick, the Financial Counsellor to the French Embassy in London, sent to the Ministry of Finance a memorandum urging devaluation, and that this memorandum was circulated among various Government departments, was strongly resented by M. Tannery. The attitude of the Bank of France stiffened, and demands for further cuts in expenditure became more peremptory.

To anyone with common sense it was obvious that on the eve of the General Election Parliament would never pass such economic measures, whose introduction would merely result in a series of Cabinet crises. Notwithstanding this, the Bank of France insisted upon its demands, threatening to withhold supplies of funds. Needless to say, it was not in a position to carry out its threats, for that would have led immediately to either the suspension of payment on Government securities or devaluation. Already arrears of Government payments were running into milliards, and the period of waiting was becoming longer and longer. To a large extent Government contracts were financed by methods similar to those of the German employment-creating bills, and these bills, drawn upon the Treasury or upon Government departments, were presented for rediscounting to the Bank of France.

(5) The London Credit and its Gold Security

The Government, in order to become less dependent upon the Bank of France, decided to negotiate a credit in London. The Bank of France is understood to have been strongly opposed to this transaction, if only because the possibility of raising funds abroad rendered the Government less dependent upon its support. Since the London banks insisted upon some form of security, the Bank of France sought to frustrate the negotiations by refusing to allow its gold reserve to be pledged as security for the credit. Eventually, however, it had to yield to some extent, and a compromise was reached by virtue

of which the credit, amounting to £40 millions, had no official security, but the Bank of France undertook to keep with the Bank of England sterling or gold equal to the amount of the credit. This was undertaken in a letter addressed by the Bank of France to the Bank of England, the text of which is as follows:

> With reference to the arrangement which has just been concluded between the French Government and the London bankers, I have the honour to confirm that the Bank of France undertakes to maintain on their account or in a dossier at the Bank of England for the duration of the credit, balances in sterling or in gold corresponding to the outstanding amount of the credit operation. Furthermore, the Bank of France will take all the necessary measures to ensure the conversion into sterling on the maturity dates of the francs delivered to them by the French Government for the purpose of repaying the credit.

The existence of this undertaking was kept secret. In this respect there was complete agreement between the French Treasury and the Bank of France. The former wanted to convey the impression that it was able to obtain a 3 per cent credit entirely unsecured in London, hoping that this would improve its chance of borrowing in the French market. The Bank of France, in its turn, wanted to continue to include in its gold reserve the amount which was unofficially earmarked as a security for the credit. There was indeed a "conspiracy of silence" in the whole French Press and in the greater part of the British Press, even after the text of the letter was reprinted in *The Financial News*.

Given the fact that the sterling or gold equivalent of the £40 millions had to be set aside for the unofficial security of the credit, it may well be asked what useful purpose the whole transaction could possibly have served. It merely amounted to using the French gold and paying 3 per cent interest on it to the English bankers. The only benefit derived from it was that it was possible during March to continue bolstering up the franc without having to disclose any substantial losses of gold. The sterling proceeds of the loan were used up and its equivalent was set aside in a special dossier in favour of the Bank of England, but the gold remained nevertheless included in the Bank of France's weekly return. This was the reason why the decline of the gold reserve during March was barely 200 million francs, even though the franc was evidently under an adverse pressure and the Bank of France was evidently losing gold.

(6) Those "200 Families"

However it may be, the transaction was utterly superfluous. It merely amounted to camouflaging the real position for a short while. The French Government, hoping that this amount would tide it over at any rate until after the General Election, was of course in a better position to disregard the Bank of France's demand for immediate economy measures. Nevertheless this same end could have been achieved also by taking a firm line with the Bank of France. By that time, the latter's moral position had become considerably undermined by the persistent campaign waged against it by the parties of the Left. During the first half of 1935 M. Flandin had not dared to dismiss the Regents and the reactionary senior officials for fear of the effect of such an action on public opinion. But since then the accusations raised against the famous "200 families", who controlled the destinies of the Bank of France by having the sole right to vote at the shareholders' meeting and by appointing the Regents, had weakened to no slight degree the influence of that institution on public opinion.

Apart altogether from those who were against the Bank on political grounds, even people whose politics were far from extreme began to wonder whether the survival of such a despotic institution in democratic France was not an anachronism. The necessity for a drastic revision of its statutes was recognised to an increasing degree. In the circumstances the Bank of France was not in a position to take too firm a line with the Government, and M. Sarraut

could have afforded to dismiss its threats as empty bluff. The response of public opinion to firm action against the Bank of France at that stage would have been distinctly favourable, and might even have influenced the result of the General Election in favour of the parties of the Centre. M. Sarraut preferred, however, not to take drastic action and to cover his immediate requirements by means of a superfluous external credit.

CHAPTER XXIV

FINANCIAL BACKGROUND OF THE RHINELAND OCCUPATION

(1) Political Effect of Repudiation of Locarno

On March 7 the world was startled by the report that the troops of the Reichswehr, acting on orders from Hitler, had entered the demilitarised zone of the Rhineland. Simultaneously Hitler announced his decision, taken in consequence of the ratification of the Franco-Soviet pact—another of M. Laval's disastrous legacies to his successors—to remilitarise that zone, in defiance of the Treaties of Versailles and Locarno. Among the many shocks delivered to Europe, this one was by far the most violent. While the withdrawal of Germany from the League, and her unilateral decision to rearm, and other acts of repudiation of the Versailles Treaty, had been taken comparatively calmly, this latest repudiation provoked a wave of indignation even in quarters which sought to take a lenient view about the previous acts on the grounds that the Treaty of Versailles was, after all, forced upon Germany. The demilitarisation of the Rhineland was, however, agreed upon voluntarily in the Locarno Treaty, and its violation shattered the illusions of those who had thought that Hitler intended to respect this treaty because it was adhered to by Germany on an equal footing.

Feelings ran particularly high in France, as the reappearance of German troops in the Rhineland brought the danger of German aggression much nearer. In fact, the immediate result was a run on the banks in the Eastern and North-Eastern provinces of France for fear of a German invasion. Troops were rushed into the fortifications of the Maginot line, and the Government was considering the idea of mobilisation, not so much for the purpose of withstanding an aggression, which in official circles was not considered imminent, as for intimidating Hitler and forcing him to withdraw his troops from the Rhineland.

(2) Need for Display of Strong Hand

Past experience has shown that the display of force is the only language which is understood in Berlin under the present régime. When in 1934 the Austrian Nazis were becoming increasingly active with the aid of German support, Signor Mussolini sought to come to an agreement with Hitler for maintaining the independence of Austria. A meeting was arranged between the two Dictators in Venice, and Hitler is understood to have promised to moderate the Nazi activities in Austria. So well did he keep his promise that a few weeks later Nazi activities broke into well-organised revolt in the course of which Herr Dollfuss was assassinated. Things looked very dark indeed, but at the crucial hour Signor Mussolini threw a few mechanised divisions up to the Brenner frontier, and thereupon Germany withdrew her active support from the Nazis, whose revolt was consequently easily quelled by the Austrian authorities.

Had France mobilised in March 1936, the march of triumph with which Hitler's Germany has proceeded from success to success would have suffered a severe reversal. For it is understood that the Reichswehr warned Hitler definitely that they were not yet ready to strike. The reoccupation of the Rhineland took place very much against the advice of the German General Staff, and on the definite understanding that if the Reichswehr troops should meet with resistance they would be withdrawn immediately, until a later hour when rearmament had reached a more advanced stage.

(3) Lack of Firmness due to Financial Reason

It may well be asked why M. Sarraut, who is known to have intended originally to mobilise, changed his mind. I am in a position to tell the authentic story of his decision. When, following upon the reoccupation of the Rhineland, the Cabinet discussed the question of mobilisation, General Gamelin, Chief of the French General Staff, was called in to give his opinion. His reply to M. Sarraut was that, while he was prepared to mobilise, he must inform the Government that the cost of such mobilisation would be six milliard francs, and that he would not assume responsibility for it unless it was understood that this amount would be forthcoming. His precaution was understandable, since, in the course of the deflationary economy campaign, the requirements of national defence were not treated any too generously and he had to safeguard himself

against being made a scapegoat for any failure due to misplaced parsimony on the part of the Government.

M. Sarraut, upon being informed of the size of the amount required, consulted with the Finance Minister and eventually decided to abandon the idea of mobilisation. Evidently the extra expenditure of six milliard francs at that stage would have provided just the last straw to break the resistance of the franc. Rather than devalue, M. Sarraut decided to leave Hitler in undisturbed possession of the Rhineland. These are facts, obtained from very well-informed quarters, whose authenticity I have no reason to doubt.

(4) Security Sacrificed in Order to Maintain Franc

World history sometimes turns on trifles. Even though six milliard francs is a formidable amount, it is a trifle compared with the tremendous issue involved. Had the French Government, by mobilising in March 1936, succeeded in inducing Hitler to withdraw his troops from the Rhineland, or had it even succeeded in obtaining an undertaking that he would abstain from fortifying the frontier, the expenditure of the six milliard francs would have been the best investment France, or indeed any other country, had ever made. It represents but a fraction of the amount France will have to spend additionally on her national defence to offset the disadvantages suffered through the remilitarisation and the refortification of the Rhineland. Even if it had led to the devaluation of the franc, it may well be asked whether the postponement of that act by six months was really of such vital importance as to be allowed to influence a major decision of foreign policy and national defence.

The bolstering up of the franc at an overvalued level required many sacrifices for France, but to sacrifice for the sake of the prolonged defence of the franc a vital necessity of national defence and European peace is an act of orthodox dogmatism for which there can be no excuse. As I pointed out in the conclusion of my book *France's Crisis*, published in 1934, "The French nation will have to choose between the franc and France." Personified by its Prime Minister, M. Sarraut, the French nation made its choice in March 1936.

(5) "Something More Important"

M. Sarraut's decision not to mobilise could not have come altogether as a surprise to Hitler. Indeed, had he expected any strong reaction to his Rhineland adventure he would never

have embarked upon it. He was only too well aware that he could ill afford the unpopularity caused by a failure of such magnitude. Being a first-rate political gambler, he is prepared to take risks, but only when he knows that the dice are loaded in his favour. He was well aware of the situation in France. He knew that with typical Latin stubbornness the French people and its Government were putting up a determined defence of their currency, and that this defence overshadowed in importance any other consideration. He was equally aware that any major war scare or mobilisation would inevitably have wrecked the defence of the franc. Therefore he must have concluded that it was reasonably safe to risk the reoccupation of the Rhineland. In order not to burn his boats altogether, he made an informal promise not to refortify the Rhineland for the time being. Had France shown a firm hand, he might easily have been induced to refrain from refortifying it altogether. But on the whole he was sure of his ground, and was certain that there was no need to expect any firmness from Paris.

The amazing attitude of the French Government reminds me of a Grand Guignol play I saw some years ago, in which a party of policemen entered a house just at the moment when a murderer was about to remove the body of his victim trussed in a trunk. A sergeant wanted to detain him to investigate the contents of the trunk, but was severely reprimanded by the inspector, who said, " Don't waste our time—we have something more important to do. We have to raid the night club." The Government of M. Sarraut, too, had something more important to do than to secure France against invasion and to reduce the chance of disturbing the world's peace. They had to " save " the franc, at any rate for another six months.

(6) Cui Bono?

It was only too glaringly evident that the prolonged resistance of France to devaluation suited Germany's interests. Indeed, whenever German newspapers expressed any opinion about the franc, they emphasised that devaluation was entirely superfluous. The *Frankfurter Zeitung* in particular was from time to time emphatic on the subject. This newspaper was allowed to retain the appearance of a limited degree of independence in order to serve the purpose of mouthpiece for statements for external consumption. Having acquired in the past the reputation for independence of views and accuracy

of news, it continued under Nazi régime to carry a certain weight in financial circles abroad, even though in reality it was as much under the control of the Minister of Propaganda as any other newspaper in Germany. Its attitude towards the devaluation of the franc was in itself sufficient to indicate the reply to the pertinent question *Cui bono?* If the mouthpiece of Dr. Goebbels was anxious that the franc should not be devalued, it was evidently not because this would have been against the interests of France. Although Dr. Goebbels is undoubtedly a noble soul, he can hardly be credited with such a degree of altruism. Had French politicians and the French public not been struck with blindness as far as devaluation was concerned, they would have realised, from the attitude of the German Press, to whose interests it was that the energies of France should continue to be paralysed by the prolonged and futile defence of the franc.

CHAPTER XXV

VERDICT OF THE FRENCH ELECTORATE

(1) Deflation Condemned

Most of the politicians who realised in the course of 1935 or at the beginning of 1936 that devaluation was inevitable were nevertheless reluctant to declare themselves openly in favour of that solution. They held the view that to do so before the General Election would be political suicide, because the French electorate was strongly against devaluation. Doubtless the French are a nation of rentiers, and the rentier classes are naturally opposed to any monetary manipulations, especially as the opponents of devaluation did their utmost to exaggerate the possible consequence of devaluation upon the purchasing power of the franc. What was generally overlooked by the French politicians was that most rentiers, besides being rentiers, had also some other occupation. They were either engaged in agriculture, in which case they were suffering from the low prices of products; or they were small artisans or shopkeepers, hit hard by the contraction of the purchasing power of their customers; or they were labourers affected by the fall in wages and employment; or they were connected with one of the innumerable trades dependent on tourist traffic; or they were Civil Servants, discontented with the repeated cuts in their salaries.

Admittedly, none of these classes was actively engaged in demanding devaluation. When M. Paul Reynaud tried to organise devaluationist opinion, he succeeded in rallying round him only a few Paris merchants particularly affected by the slump in tourist traffic. The majority of those who in their various capacities stood to benefit by devaluation did not express any very definite opinion as to whether they wanted devaluation. They were, however, very definite in disapproving of the deflationary policy pursued by the various Governments, especially by M. Laval. The latter's promise of a fall in the cost of living, to compensate for the various cuts, had not materialised. In the circumstances, those parties which bore the responsibility for M. Laval's deflationary

policy could not expect the rentier classes to be grateful. They antagonised practically all other classes with the exception of the ultra-Conservative financial and industrial " Upper Ten ". This reactionary clique was hoping against hope that, by enforcing reckless deflation, it might induce Government and Parliament to repeal, for the sake of reducing the cost of production, the *Loi des Assurances Sociales*. Although this piece of social legislation lags far behind British social legislation, it has always been regarded as obnoxious by the French diehards who hoped that the defence of the franc would provide an opportunity for throwing it overboard.

(2) Responsibility for Deflation

It was to a large extent the identification of the monetary policy pursued by the moderate parties with these reactionary elements which influenced the result of the General Election. Communist and Socialist propaganda made full use of the combined unpopularity of the deflationary policy and of the big financiers and industrialists controlling the Bank of France. M. Delaisi's denunciation of the " 200 families " who had the sole right to vote at the Bank of France's meetings found fertile soil amidst the discontent caused by years of deflation. The feudalistic idea of limiting the voting rights to the large shareholders only antagonised the electorate in a democratic community, all the more as the nominees of the 200 families pursued a policy which, besides being harmful, was also highly unpopular. While it would have been futile to try to explain to the public the economics of deflation and devaluation, they began to realise vaguely that the policy dictated to the country by the Bank of France was the root of all evil, and that the Regents were the real villains of the piece.

The parties upon which responsibility for deflation rested were in the first place those of the Centre and moderate Right. The Radical Socialist party, which in the last Parliament had been the largest, and which supported the deflationary measures of M. Laval only reluctantly and under protest, had nevertheless to share their unpopularity. After all, without their support M. Laval could never have obtained full powers to enforce cuts, and in any case they would have been in a position to summon Parliament when they found that M. Laval's measures went rather beyond their limit. They abstained, however, from doing more than protesting against some of the economy measures. They did not withdraw their leaders from M. Laval's cabinet; and when it came to a decision

they even ratified the proposed measures almost unchanged. In the eyes of the public they were as much responsible for the orgy of deflation as the parties of the Centre and moderate Right, which supported M. Laval actively.

(3) Fresh Flight from the Franc

Throughout the electoral campaign the parties of the Left made full use of the unpopularity of deflation. On the other hand, they carefully refrained from appearing as though they were in favour of devaluation. The gross inconsistency of their programme was evident, but it would have required a certain amount of knowledge of economics to realise it, and since many politicians, bankers, financial journalists and Professors of Economics in France and elsewhere did not appear to possess that minimum amount of economic knowledge, it is not surprising that the general public did not possess it. They genuinely believed it possible to condemn deflation without favouring devaluation. Indeed, the various parties were outbidding each other in denouncing devaluation and disclaiming any intention of resorting to monetary manipulations. Believing that the electorate was against it, all parties, from the extreme Royalists to the Communists, pledged themselves to maintain the franc at its existing parity. M. Reynaud was the only one who, at the risk of losing his Paris seat, continued to advocate devaluation. Throughout the campaign M. Blum and his Socialist followers spared no effort to make it plain that they would refrain from interfering with the value of the franc. Both Socialists and Communists emphasised that a devaluation of the franc would lead to a reduction of real wages, and repudiated any intention of taking such a course.

Notwithstanding this, anticipation of the victory of the parties of the Left was largely responsible for the flight from the franc during the few weeks that preceded the Election. Early in March the weakness was due to the war scare created by the reoccupation of the Rhineland, but before long it became evident that, as France did not intend to take a firm line, there was no immediate danger of war. Nevertheless, the pressure on the franc continued as the electoral campaign proceeded. At the end of March it became necessary to raise the bank rate from $3\frac{1}{2}$ to 5 per cent, for even though the visible loss of gold during March was only 200 million francs, the proceeds of the London credit, amounting to 3 milliard francs, had to be used up in order to prevent a bigger reduction of the

gold reserve. Needless to say, a 5 per cent bank rate was unable to check the drain, which continued through April. On April 24, two days before the date of the Election, the gold reserve was 62,488 million francs compared with 65,587 million francs at the end of March.

(4) Anticipation of Socialist Victory

There were several reasons why the anticipation of a Socialist victory led to a flight from the franc, notwithstanding emphatic assurances that a Socialist Government would continue to follow its predecessors' monetary policy. In the first place, many people were not prepared to take these pledges at their face value. After the experience of the last few years it has become an understood thing that any intention to devalue should be strenuously denied until the actual moment of devaluation. Moreover, it was widely assumed that, even if a Socialist Government had every intention of maintaining the franc at its old parity, it would be unable to fulfil its pledge owing to the sweeping flight of capital that was expected to follow its victory. Above all, the flight of capital from France was no longer a mere flight from the franc. It was to a large and increasing degree also a flight from the anticipated increase of taxation and anti-capitalist measures that a Socialist Government was expected to introduce. Indeed, many Socialists, and especially Communists, openly advocated during the electoral campaign the adoption of a capital levy. The result of this was not only the accentuation of the export of capital but also an increase of the internal hoarding of Bank of France notes, on the assumption that holders of notes would escape capital levy. During March the note circulation increased by nearly 2 milliard francs, and in April it increased by an additional milliard.

The result was an accentuation of the monetary stringency to an almost unprecedented degree. Throughout April the market rate of discount was actually above the official rediscount rate. Such was the extent of the withdrawals that even those leading banks which had hitherto always succeeded in avoiding having to fall back on the Bank of France had to avail themselves of the facilities offered by that institution.

(5) Electorate Rejects Deflation

On April 26 the French electorate cast its vote. The result was a strong increase of the parties of the advanced Left, and the strengthening of the parties of the advanced Right, at the

expense of the Centre, the moderate Left and the moderate Right. The Radical Socialist party suffered the penalty of trying to run with the hare and hunt with the hounds. It lost the predominant position gained at the Election of 1932, and ceased to be the largest party in the Chamber. The lead was taken by M. Blum's Socialist party. What was even more alarming to the French wealthy classes was the remarkable success of the Communists, who became a party of considerable importance in the Chamber. Altogether the parties of the Front Populaire, which included the Radical Socialists, Socialists and Communists, obtained a large clear majority, and the composition of the new Chamber was such as to make it impossible to form a Government of the Left without the support of the Communists and to make it impossible to form any Government without the support of the Socialists.

This result was more or less in accordance with anticipations. It could not be interpreted as a national pronouncement in favour of devaluation, since, as we said above, all parties declared themselves against it during the electoral campaign. Indeed, M. Reynaud retained his constituency only with the utmost difficulty and with a considerably reduced majority, which showed that to advocate devaluation was anything but popular with the public, even in Paris where a large percentage of the population depends on tourist traffic. On the other hand, the result made it plain that the French electorate emphatically rejected the deflationary policy pursued by M. Laval. In a negative sense the election result was thus conclusive beyond doubt. Even quarters which until the eve of the Election urged the Government to continue the reduction of expenditure had to realise, in face of the overwhelming victory of the parties criticising the deflationary policy, that their game was up.

The parties which were responsible for deflation got what they amply deserved. M. Laval faded into the background and the number of his supporters became reduced. He ceased to be regarded as the French equivalent of the Leader of the Opposition. That institution is unknown in France, owing to the multiplicity of parties, but if there was one name that was outstanding as the prospective Leader of the group of parties of the Centre and moderate Right, it was that of M. Reynaud.

in Chapter XXVIII how the advent of the Socialist Government was the signal for a series of stay-in strikes, with all their demoralising effects upon discipline and the unity of the nation. The prestige of France as a factor in international politics sank to the lowest point ever reached since her recovery from the defeat of 1871. Indeed, Berlin began to regard Paris as a *quantité négligeable* which could safely be ignored owing to internal weakness and dissension. It was because France was so evidently weak and divided that her allies deserted her one by one. There was a strong *rapprochement* to Germany in the Yugoslav and Roumanian foreign policy; Belgium declared herself to be neutral—that is, while she was prepared to accept being defended by France and Great Britain, she declared herself to be no longer prepared to fight for other nations if they were subject to aggression. Poland, while graciously accepting a French loan, continued to nurse her friendship with Berlin.

It was mainly as a result of the Socialist victory in France that Herr Hitler and Signor Mussolini definitely decided to join forces. They have succeeded in achieving between them an incontestable hegemony over the continent. Last, but by no means least, it was the decline of France as a factor in international politics that encouraged Italy and Germany to support General Franco's adventure in Spain. Had the Government of France been in the hands of a strong Conservative and Nationalist Government, ready to strike when France's vital interests were endangered, it would have been too risky for Italy and Germany to violate so openly and to such an extent their non-intervention pledge. As it was, they assumed that the French General Staff would never agree to action against their Spanish colleagues in support of Socialists, Communists and Anarchists. Their assumption was probably not far wrong and may explain, in part at least, the non-intervention policy adopted by M. Blum. If General Franco eventually succeeds in breaking down the resistance of Señor Caballero's troops, and if he establishes an efficient Fascist state

subsidised by Rome and Berlin, menacing the Southern frontiers of France and the Mediterranean route of Great Britain, it will be the result of the French anti-devaluationary policy, which was responsible for the fateful victory of the Front Populaire.

It is true that, towards the close of 1936, M. Blum succeeded in enforcing a certain degree of discipline among his followers, and this, together with the firmness shown by France against a German penetration into Morocco, restored much of France's lost prestige in the sphere of international politics. What was even more important, the devaluation of the franc in the eleventh hour prevented the outbreak of the revolution in France which was fully expected in Berlin for the autumn of 1936. Nevertheless, during the four months or so while France was eclipsed, Hitler gained success after success, which encouraged him to become more and more aggressive. By the time M. Blum was able to reassert himself, Hitler was safely entrenched.

CHAPTER XXVI

AFTER THE FRENCH ELECTION

(1) "INTERREGNUM"

THERE is a certain degree of similarity between French and American constitutional practice. In both countries an Election of vital importance is held every four years, and several elections of minor importance take place between these major elections. In both countries, if the major Election results in a political change, it does not immediately materialise as soon as the result is known. While in Great Britain the Government which is defeated at an election resigns immediately and gives place to the party which commands a majority in the new Parliament, in the United States two months have to elapse (formerly the period was four months) between the Election and the change of Administration. In France, too, it is the practice that the Election should take place in April and that the new Parliament should not meet before June. In the meantime the outgoing Government carries on, just as the outgoing President remains in office in the United States until the date of the change.

The disadvantages of this system are obvious. They were realised in the United States, where the period of "interregnum" was reduced from four months to two. But even the month or so that separates the French General Election from the change of Government is sufficiently long to show the disadvantages of the "interregnum". The outgoing Government has no prestige and very little power except to carry on current affairs. It cannot take any major decision. Its pledges or threats carry little weight. In normal conditions these inconveniences are by no means intolerable, but during periods when situations arise that require firm handling they may easily prove fatal.

In the spring of 1936 it was essential from a financial and political point of view that France should have a strong Government. It was particularly unfortunate therefore that the Administration was carried on during May by a defeated Government which was not in a position to exert its authority

or take any major decisions. It would have been to the best interests of France if, as soon as the Election results became known, M. Blum had taken over the Government from his predecessor. This was, however, contrary to constitutional practice. Although it would have been possible to come to an arrangement, M. Sarraut was not too keen on relinquishing office before June, nor was M. Blum over anxious to assume it.

(2) Credit Expansion in Spite of High Bank Rate

During the interregnum of May the Sarraut Government confined itself to routine measures for the defence of the franc. On May 6 the bank rate was raised once more to 6 per cent. This was considered necessary because during the week that followed the General Election the Bank of France lost gold to the amount of nearly 1,170 million francs. Evidently the situation had become aggravated and threatened to assume a panic-like character. The futility of raising the bank rate should have been evident. While on previous occasions it had been possible to restore confidence through the solution of the political crisis responsible for the wave of distrust, on the present occasion there was nothing to be done in face of the victory of the Front Populaire. Moreover, a high bank rate could only be effective in discouraging the flight of capital and speculation if it were accompanied by drastic credit restrictions. In the conditions prevailing in France in May 1936 there could be no question of any curtailment in the volume of currency or credit. Even before the increase of the bank rate, money conditions were so tight that the Bank of France had to extend its support to the banking and commercial community rather than curtail its loans. The cash reserves of the French banks had become depleted to a considerable degree as a result of the heavy withdrawals of deposits in March, April and May. This is indicated by the fall in the amount of private deposits with the Bank of France. In 1932 this amount was more than 25½ milliards of francs, from which figure it gradually declined to 8,168 million francs by the end of March 1936, and to 6,684 million francs by the beginning of May.

The extent to which the increase of the bank rate was accompanied by an expansion of credit is illustrated by the rise in the figures of discounts from less that 10 milliards at the end of February to more than 12 milliards at the end of March, to more than 15 milliards at the beginning of May and to the record figure of 19,395 millions at the end of May.

Thirty-days' advances also rose to more than one milliard francs at the beginning of May, while advances on bullion and on securities also showed expansion. At the same time the note issue, which had already increased by nearly 3 milliard francs during March and April, further advanced by more than half a milliard during May. In face of these figures it may well be asked what useful purpose a 6 per cent bank rate could possibly fulfil. It certainly did not check the expansion of credit and did not discourage the flight of capital.

(3) Reassuring Statements

Nor did the reassuring statements issued by M. Sarraut and his Finance Minister, M. Régnier, carry any weight, since their régime was to come to an end in June. Confronted with a sweeping flight of capital, M. Sarraut is understood to have intimated to M. Blum that his Government was unable to carry on until June unless the Socialist leader was prepared to reaffirm his pledges against devaluation. Unfortunately M. Blum was not at that time quite ready with his plans for taking over the Government. Negotiations with the various parties of the Front Populaire were still in progress, not only regarding the composition of the Cabinet but also regarding the programme to be adopted. It was difficult to arrive at a programme which was acceptable to both the Right Wing Radical Socialists and the Communists.

M. Blum was therefore anything but keen to assume office before June. M. Sarraut, taking advantage of this, pressed him to commit himself to an anti-devaluationist policy. Although the Socialist party had already declared itself to be against devaluation during the electoral campaign, it was one thing to assume a commitment before Election and another thing to reaffirm it when as a result of the Election the party was to assume the Government within a few weeks. It was a great pity that M. Blum allowed himself to be persuaded to comply with M. Sarraut's request. His commitment of May made it more difficult for him to change his attitude towards devaluation after assuming office.

(4) French "Invasion" of London

Nor did the reassuring statements by the outgoing and prospective Governments produce the desired effect. The flight of capital continued unabated. In the course of April and May there was an invasion of the City of London by Frenchmen and Frenchwomen making arrangements for

sterling balances or gold deposits in London banks. Safe deposit accommodation available in London became completely exhausted. Even the most old-fashioned safes, which could be easily burgled with the aid of a bent hairpin, were eagerly taken. Day after day new accounts were opened by the dozen at each of the leading banks, and since the number of officials speaking French was limited, their waiting-rooms were crowded and in at least one instance there was a long queue standing in front of the door of an official dealing with the French clients. The arrival of Frenchmen or Frenchwomen in taxis, carrying one or two bars of gold or dispatch-cases bulging with franc notes, and trying to look as unobtrusive as possible, ceased to be an unusual sight. Day after day large amounts of franc notes were bought by the London banks and transferred to their Paris offices or their Paris correspondents. The more cautious banks declined after a while to buy large amounts of francs outright and only took them for collection, crediting their clients' accounts after their Paris representative had bought sterling to the equivalent of the notes.

During these months thousands of new accounts were opened in London alone, and there is reason to suppose that Brussels also had its due share in the new French refugee funds. Owing to distance, New York did not get quite as much as London, though large amounts were transferred to New York through the intermediary of London. All the owners of these new accounts, big and small, were above all anxious to cover their tracks. This was the reason why they preferred to come over personally instead of arranging the accounts through their banks or even through direct correspondence with London banks. The fact that French capital found its way also to Holland and Switzerland for investment in Dutch and Swiss shares shows that fear of devaluation was by no means the only motive for its flight from France.

(5) Unofficial Embargoes

The evidence of this wholesale flight of capital disposed of the ingenious theories put forward at the beginning of the year that the resources available for transfer abroad or for hoarding had been exhausted. Between the beginning of January and the end of May the Bank of France lost nearly 10 milliard francs in gold in addition to the 3 milliard francs of the proceeds of the sterling credit used up in defence of the franc. Nor was there any indication that the flow of funds was drying up. In the course of May the French authorities resorted to a new

method of defending the exchange. As early as August 1935 the French banks were requested to refrain from speculative Forward Exchange operations. This request was, however, disregarded whenever a wave of distrust resulted in new selling pressure on the franc. In May 1936 the French authorities repeated their request and asked the banks at the same time to abstain from assisting their clients in transferring their funds abroad.

To some extent, at any rate, these unofficial embargoes were observed. Coming events were casting their shadows before, and the fear that the Socialist Government might investigate the books of the banks was a fairly effective deterrent. The embargoes were, of course, far from watertight, and in any case a large number of Frenchmen were capable of establishing direct contact with foreign banks. At the same time in London, and to a less extent in other centres, the authorities endeavoured to assist the French authorities in the defence of the franc by imposing new unofficial embargoes and reinforcing the existing ones tending to discourage attacks on the franc and, to some extent, the hoarding of gold coins. Notwithstanding these measures of co-operation, the drain on the Bank of France's gold reserve continued. Possibly in the absence of such measures it would have been even greater.

(6) Treasury's Difficulties

Simultaneously with the external drain, the internal drain due to the budgetary deficit also continued. For a long time the Treasury's balances with the Bank of France were under 100 million francs and the balances of the *Caisse Autonome d'Amortissement* were also declining. The spectacular increase of discounts during May was largely the result of Treasury borrowing. The proceeds of the London credit were exhausted before the Election, and the financing of the deficit by inflationary methods had to be resumed. Indeed, the Treasury was in an appalling state, and the task of any Government which had to take it over from its predecessor was anything but enviable.

This was the state of affairs at the moment when M. Blum assumed office. Whatever criticism he deserves for his subsequent contradictory and vacillating policy, it must be admitted in all fairness that he inherited a situation from his predecessors for which the Governments of MM. Laval and Sarraut were mainly to blame. While it is true that the anticipation of his advent accentuated the flight from the franc,

it is equally true that, but for the disastrous conditions in which Conservative and semi-Conservative Governments had left French finances, the strain would not have been unbearable.

It was amidst such hopeless conditions that M. Blum was induced to commit himself to an anti-devaluationist policy. He was fated to carry for nearly three months the burden of this policy. Nor did his opponents make it any easier for him to carry this burden.

CHAPTER XXVII

ORTHODOX DEVALUATIONISTS

(1) Sudden Changes of Opinion

We saw in the last chapter how the victory of the Front Populaire at the French Election reacted upon the financial situation in France. Let us now see how it reacted upon the movement in favour of devaluation. As we have seen before, the extent of the open movements in favour of lowering the gold content of the franc was, until the Election, negligible. Most of those politicians, bankers, Treasury officials, economists and journalists who disapproved of the futile defence of the franc at an overvalued rate took good care not to give away their views. Indeed, many of them continued to pay lip-service to monetary orthodoxy right up to the eve of the Election. To judge by the public statements and articles appearing in the French Press, opinion in France was almost unanimous in condemning devaluation.

This state of affairs underwent a change after the Election. In the course of May and June a number of theoretical and practical experts openly declared themselves in favour of devaluation, at first timidly and with many " ifs " and " buts ", and then gradually more and more unreservedly. Nor was it from the camp of Radical politicians or economists that this unexpected support to devaluation was forthcoming. On the contrary, it came from the ultra-orthodox quarters, which, as if by a miracle, appeared to have become converted overnight in favour of a Radical monetary policy.

(2) Enter Professor Rist

M. Charles Rist, a former Professor of the Paris University and subsequently deputy-Governor of the Bank of France, was the first to desert the sinking ship of anti-devaluationism. His whole past record was one incessant fight to uphold the principles of monetary orthodoxy. Indeed, he was among the most reactionary arch-deflationists, even before 1931. During the Anglo-French controversies of 1929–31, he was the spear-head of the French attack on what they regarded as unorthodox

tendencies in the British monetary policy. It will be remembered that since the pound was out of equilibrium, largely as a result of the undervaluation of the franc in 1928, and since the restoration of equilibrium through ruthless deflation was both economically inexpedient and politically impossible, the British authorities based all their hopes on a rise in world prices which would restore the equilibrium of the pound without any deflation in Great Britain.

One of the factors which tended to work in that direction was the widespread adoption of the gold exchange standard. By virtue of that system the same balances were able to serve as a basis for credit expansion in two countries at the same time. In practice the extent to which the gold exchange standard did actually serve as a basis for credit expansion was comparatively negligible. Even though a number of Central Banks were entitled to issue notes on the security of their foreign balances, they usually held these foreign balances as safety margins and no notes were actually issued against them. Above all, the largest holder of Foreign Exchange was the Bank of France, and that institution was not entitled to include its Foreign Exchange holdings in its metallic reserve. Notwithstanding the evidence of facts—which were discussed in detail in my book *World Finance Since 1914*—a determined campaign was waged against the gold exchange standard, on the ground that it was apt to give rise to dangerous international credit inflation. M. Rist was the loudest in denouncing the gold exchange standard as the root of all evil, actual and potential. Both before and after the crisis of 1931 he was the loudest—with the possible exception of Professor Lionel Robbins, who made a valiant effort to out-Rist M. Rist in that respect—in denouncing Great Britain as the villain of the piece, on the ground that she refused to take the necessary deflationary measures for bringing the pound back to equilibrium.

(3) Conversion of an Arch-Deflationist

After the suspension of the gold standard in Great Britain he was one of the most ardent believers in the cult of lower prices and lower wages as a means for France to struggle against the consequences of the overvalued franc. During the world Economic Conference in London in 1933 he proved himself to be by far the ablest spokesman of the Gold Bloc, and in the course of the international stabilisation offensives which preceded and succeeded that Conference he was amongst

the foremost critics of Great Britain's unwillingness to stabilise at an inconvenient time and at an inconvenient level. Needless to say, he expressed himself against the devaluation of the franc on innumerable occasions.

Towards the end of 1934 I learned from usually well-informed quarters that M. Rist had begun to waver in his attitude towards devaluation. He did not, however, declare his change of views, even after the franc crisis of May 1935. It is true that he began to advocate devaluation, but only as part of an international stabilisation scheme. And since Mr. Chamberlain had made it plain beyond doubt that Great Britain was not yet prepared to stabilise and was not likely to change her monetary policy for a long time to come, in practice M. Rist's proposal had very little meaning. It created a certain amount of stir, which died down, however, amidst the short-lived triumph of orthodoxy that followed the adoption of deflationary measures by M. Laval.

It was not until the victory of the Front Populaire that M. Rist revealed himself as a 100 per cent devaluationist. Indeed, considering the zeal with which this new convert threw himself into the movement, it is no exaggeration to say he was a 105 per cent devaluationist compared with whom M. Reynaud was almost orthodox.

(4) M. Germain Martin and Devaluation

Another prominent convert to devaluation was one of M. Rist's former colleagues at the University of Paris, M. Germain Martin. He was responsible, among others, for M. Doumergue's deflationary measures. Under M. Flandin he was prepared to adopt the deflationary policy dictated by the Bank of France, but his Government was defeated at the end of May 1935. In his unofficial capacity he took an active part in the campaign aiming at inducing the British Government to stabilise sterling. This campaign culminated in an attempt, on the occasion of the International Parliamentary Conference in the autumn of 1935, to persuade British Members of Parliament to bring pressure to bear upon their Government in order to induce Mr. Chamberlain to change his policy. Mr. Chamberlain, incensed by this attempt to get at Members of Parliament over the head of their Government, retaliated by reasserting more emphatically than ever his determination not to stabilise. After the victory of the Front Populaire, M. Germain Martin followed the example of M. Rist and advocated the adherence of France to the Sterling Bloc after the devalua-

tion of the franc. At first he suggested some form of compromise by which the franc was to retain its internal value while it was devalued internationally, but subsequently he became a 100 per cent devaluationist.

(5) Lesser Diehards Capitulate

Among the lesser lights who followed the example of their betters, M. Frédéric Jenny, Financial Editor of *Le Temps*, occupied a prominent place. He shared with M. Michel Mitzakis, Financial Editor of *L'Intransigeant*, the privilege of acting as spokesman of the Bank of France. Long after everybody else had realised that further deflation was politically, economically, financially and even arithmetically impossible, these two financial journalists continued their campaign demanding drastic cuts and more cuts. They were equally prominent in denouncing indignantly any suggestion that the franc was vulnerable or that the remedy for the situation was devaluation. M. Mitzakis was the first of the two to change his front after the Election, admitting that devaluation was inevitable. M. Jenny was the last among the *chevaliers sans peur et sans reproche* to capitulate. He was an extremely bad loser, blaming everybody but himself and the policy he had supported for years for the development of a situation which, in his view, made devaluation inevitable.

M. Jenny, and other new converts, maintained that while devaluation had not been necessary prior to the General Election, it had become inevitable as a result of the Socialist victory. They duly realised that a Socialist Government would be unable to enforce deflationary cuts, and also that it had to face a sweeping flight of capital. What they refused to realise was that deflation in France had reduced itself *ad absurdum* long before the advent of the Socialist Government, and that the Socialist victory was the logical and inevitable consequence of the deflationary policy pursued with their full approval by M. Laval and his predecessors. Their excuse, that in 1935 they had had every right to be against devaluation since they could not foresee that the General Election would return a Socialist Government, sounds very lame indeed. They ought to have realised that the French people would not put up indefinitely with a deflationary policy, and that the persistent pursuance of such a policy would inevitably play into the hands of one or other of the extremist parties.

(6) Making M. Blum's Task more Difficult

I have mentioned only a few characteristic examples of overnight conversions in favour of devaluation. There were many other prominent people in various spheres, including members of the Regency council of the Bank of France, who became suddenly enlightened as soon as the Election result was known. The attitude of the majority had a distinctly political flavour. While the Government in office was according to their liking they supported its monetary policy even though they duly realised its consequences. With the victory of the Front Populaire these "impartial" experts went promptly into opposition. And since M. Blum's declared intention was to continue to defend the franc, it was the opposition's object to make his task more difficult by agitating in favour of devaluation. Few of the politicians of the Centre and the Right declared themselves openly in favour of devaluation, even at that stage. They left this to their friends among the economists and journalists.

The attitude of this devaluationist campaign, which began in May and which continued after the advent of M. Blum's Government in June, may be summarised as follows:—"So long as a Moderate Government was in office there was every hope of deflating successfully and of defending the franc. Under the Socialist Government, however, it is hopeless to attempt to defend the franc, and therefore the best thing to do is to devalue without delay." By the adoption of this ingenious formula many of M. Blum's opponents pursued a twofold aim. The intensification of demand for devaluation was calculated to accentuate the flight of capital from France. It stands to reason that the French public was bound to be affected in its attitude by the evidence of wholesale conversions in favour of devaluation on the part of those who had hitherto been ardent supporters of orthodox financial methods. The effect of a speech or article by some former leading member of the anti-devaluationist camp was bound to be much stronger than anything an old devaluationist like M. Reynaud could possibly do or say.

The agitation by former anti-devaluationists increased the difficulties of the defence of the franc to no slight degree. At the same time it also forced M. Blum to continue defending the franc in spite of the increased difficulties. Had M. Blum devalued as soon as he assumed office, he would have confirmed the thesis of his opponents according to which devaluation was

the consequence of the advent of his Government. It was largely because of the devaluationist agitation on the part of his opponents that he must have decided to prove that the franc could be defended under a Socialist Government as well as under any other Government. While there could be no excuse for unnecessarily prolonging the agony by three months, the responsibility for this futile waste of time and energy is due in part at least to those who became converted in favour of devaluation in circumstances in which their attitude was likely to increase M. Blum's difficulty in deciding upon devaluation.

CHAPTER XXVIII

SQUARING THE CIRCLE

(1) Radical Anti-Devaluationists

In the last chapter we discussed the orthodox devaluationists. In this chapter we propose to discuss the Radical anti-devaluationists. As we have seen, Conservative and reactionary quarters suddenly turned Radical shortly before or after the advent of M. Blum's Government. Simultaneously those whose political past would have justified the adoption of a Radical monetary policy turned ultra-orthodox. M. Blum and his Finance Minister, M. Vincent Auriol, former advocate of an expansionary financial policy, became, for three months at any rate, the supreme defenders of the creed of monetary stability at all costs.

As far as M. Blum himself was concerned, he is known to have been all along in favour of devaluation, but for political expediency he postponed the change, awaiting an opportune moment. M. Vincent Auriol, on the other hand, was a convinced anti-devaluationist. He is more or less the French equivalent of Lord Snowden, the Socialist with orthodox leanings in matters of monetary policy. The difference was that while Lord Snowden's ability as a financial expert was admitted even by his opponents, M. Auriol's innocence of any profound knowledge of finance was a matter of general knowledge even among his supporters. His stubborn orthodoxy was not the least of the difficulties with which M. Blum had to cope before eventually adopting the right solution. There can be no doubt that, had it been politically possible, he would have preferred to have M. Reynaud to advise him on monetary policy. In the course of the debates, M. Blum was noticed to have been following M. Reynaud's devaluationist speeches with the greatest of attention and with ill-concealed approval.

(2) Monetary Orthodoxy of Communists

The reason why M. Blum for three months followed M. Auriol's policy instead of M. Reynaud's was the attitude of the Communists towards devaluation. Their leader, M. Thorez,

launched an anti-devaluationist campaign worthy of a M. Laval or a M. de Wendel. He denounced devaluationary suggestions as an attempt to deprive the working classes of the benefits of the wage increases they had enforced during June. The fact that Conservative quarters had turned in favour of devaluation strengthened the effect of his campaign. Although he declined to take part in the Government, he was prepared to support it subject to certain conditions, one of which was that the franc was not to be devalued. M. Blum believed he could ill afford at that stage to disregard the wishes of the party upon whose support the existence of his Government depended. He was anxious to pass a number of social reform measures urgently, and to that end he required the full support of the Front Populaire. A split in the Front Populaire would have frustrated his plans, or at any rate would have delayed the adoption of the social reform measures by several months. He was therefore prepared to abstain from devaluation, at any rate pending the passing of the social reform measures. M. Thorez thus succeeded in preventing devaluation after the advent of the Socialist Government.

In the last chapter we saw the mischievous motives behind the sudden conversion of Conservative quarters to devaluation. The opposition of Communists to devaluation was prompted, however, by motives hardly less sinister. Although M. Thorez and his adherents had every reason to be satisfied with the unexpected progress they had made at the General Election, they fully realised that by constitutional methods they would never be able to assume power. The majority of the French electorate had rejected Communism, even though the Communists were wise enough to hoist the tricolour beside the Red Flag and to sing the "Marseillaise" after the "Internationale", and even though they declared that they would not touch fortunes up to half a million francs. They realised that their only hope of supremacy was an utter deterioration of conditions in France. What they wanted was economic collapse and chaos so as to be able to fish in troubled waters. It suited their purpose, therefore, that M. Blum should continue to resist devaluation, thereby accentuating the trade depression and the atmosphere of tension which might lead to open explosion.

(3) Social Legislation

In reality, as subsequent events proved, the anti-devaluationist bark of M. Thorez and his Communists was a great deal worse than their bite. There was actually no need for M. Blum

Yielding to pressure on the part of MM. Thorez and Auriol, and irritated by the devaluationary campaign of his political opponents, M. Blum declared himself against monetary manipulations immediately after his advent to office. At the same time he set out to pass a number of measures whose inevitable result was an aggravation of the pressure on the franc. He rushed through a number of bills enforcing the 40-hour week and paid holidays. Praiseworthy as the object of these bills was in a country where social legislation had been, before his advent, in a very backward state, it certainly did not help in defending the franc. For the bills were to bring about a considerable increase in the cost of production and were therefore bound to increase the existing disequilibrium of the franc. The maintenance of the franc at its old parity was difficult even before the adoption of these measures. If we assume that in May 1936 the franc was overvalued against sterling to the extent of, say, 25 per cent, other things being equal, after the application of the 40-hour week, paid holidays and other social legislation, the extent of the overvaluation was to be expected to be something like 50 per cent.

(4) Stay-in Strikes

The application of the new measures was to take some time, and its immediate effect upon the franc was psychological rather than material. On the other hand, the franc was directly affected in June by the all-round increase in wages, and still more by the methods by which these increases were enforced. The advent of M. Blum's Government was greeted with a series of stay-in strikes, which at one time almost assumed the character of a General Strike. It is easy to understand that the French workmen, having meekly submitted to cut after cut during the deflationary period, became exasperated and felt that after the Socialist victory the time had arrived for reversing the trend. What is highly deplorable

is that the workmen did not restrain their impatience for a few weeks, giving M. Blum a chance to obtain for them by legal means all there was obtainable. Instead, employees in every branch of industry and commerce all over France took the law into their own hands and forced their employers, by methods which were little short of revolutionary, to grant increases of wages and improvements of working conditions.

The stay-in strikes, combined with the " imprisonment " of directors and proprietors at the occupied premises, had come to be regarded as the normal weapons with which workmen were to enforce their claims. And this at a time when the Government was in the hands of Socialists, who would in any case have supported with all their strength the legitimate demands of the working classes. Indeed, it was exactly because the workmen felt that they could depend upon the support of the Government, or at any rate upon the absence of any official intervention to restrain them, that they embarked upon wholesale violence and illegality. The conditions prevailing in France in June 1936, and to a less extent in subsequent months, went a long way towards discrediting French Socialism, owing to the lack of discipline among its supporters. They also lowered the prestige of France abroad, where the widespread stay-in strikes were interpreted as the early stages of revolution and Civil War.

(5) Trade Deadlock

Had M. Blum devalued the franc in June, there would have been no need to make France the scene of such wholesale disorder. The rising trend of commodity prices would have enabled employers to comply with demands for higher wages without any resistance. As it was, employers were forced to raise wages, while at the same time the rigidity of the franc deprived them of the hope of a corresponding rise in commodity prices. Indeed, the increase of costs through social legislation and new wages agreements wiped out the margin of profit in a number of instances. In the absence of an adequate rise in commodity prices, industrial undertakings would have had to work at a loss. Many of them preferred to close down or restrict activity. The reason why the events of June were not followed by a spectacular increase of unemployment in France was that the majority of employers preferred to wait and see. They realised that devaluation was bound to come sooner or later, and decided to mark time in the meanwhile. In any case, Frenchmen seldom take any major decision in

their business during the summer vacation. There can be no doubt, however, that had the resistance to devaluation continued during the autumn, France would have witnessed an unprecedented increase in unemployment, especially with the gradual application of the 40-hour week. As it was, a number of industrial and commercial employers reduced their activities and transferred their capital abroad.

What took place in France after the advent of M. Blum's Government amounted to nothing less than an attempt at squaring the circle. It is possible within limits for a Government to defend an overvalued currency by means of drastic deflation, provided that its nationals are prepared to put up with that policy. It is also possible for a Government to adopt a number of measures bringing about a drastic increase in the cost of production. What is utterly impossible is to try to combine the two aims—to defend the franc and at the same time to increase its overvaluation by deliberate measures.

(6) Reflation without Devaluation

M. Blum's Government went even further. Apart from passing measures resulting in the increase of the cost of production and prices, it contemplated a series of measures increasing Government expenditure. Ambitious public works schemes were being elaborated and new social expenditure was undertaken. The result was inevitably an increase of the budgetary deficit, which was heavy enough before the advent of the Socialist Government. The official policy was distinctly reflationary, aiming at trade recovery through public works and cheap money. This, together with the social legislation measures, was bound to undermine the resistance of the franc.

Absurd as the apparent determination to defend the franc was in such circumstances, it must be admitted in all fairness to M. Blum's Government that the difference between its monetary policy and that of its predecessors was merely one of degree in absurdity. Even the arch-deflationary Government of M. Laval had been inclined to pursue a certain degree of reflation in the form of cheap money and public works. In addition it had had to pursue a high degree of reflation because of the sheer impossibility of balancing the budget or covering the deficit by means of normal borrowing. The reflationary factors increased further under the Government of M. Sarraut, and would have been sufficient to undermine the defence of the franc in the course of time even in the

absence of social legislation. All M. Blum did was to accentuate and accelerate the process which was already in existence.

(7) Preparing the Way for Devaluation

It must be said for him that even though he had not the courage to take the plunge immediately after assuming office, he was eagerly awaiting his opportunity to terminate the deadlock. Once the formidable batch of social legislation was safely passed in record time, he thought the moment had arrived to make a move to prepare the way to devaluation. Instead of launching a frontal attack on anti-devaluationist resistance, he sought to circumvent it. The proposed reform of the Bank of France appeared to provide a good opportunity for this purpose. The reform bill, as originally prepared and introduced was an enabling bill authorising the Government to alter the laws and statutes governing the Bank of France. The object of this measure was evident. Since the law of June 1928 fixing the value of the franc at 65½ milligrammes of gold was amongst the laws and statutes governing the Bank of France, the new bill was to empower the Government to change this law by reducing the gold contents of the franc or by suspending the convertibility of the franc into gold. This was only too evident, and yet the Bill passed in the early stages without any opposition. It is to be assumed that some of the politicians of various parties at least must have noticed that the bill would enable M. Blum to devalue the franc or to suspend the gold standard, but they preferred to ignore the point so as to leave to the Government the whole responsibility for devaluation. They realised that sooner or later they would have to pass a devaluation bill, and in doing so they would have to assume part of the responsibility for that measure. It would have suited their purpose for devaluation to have been smuggled in through the back door under false pretences rather than admitted through the front door.

The check to the progress of the measure came from unexpected quarters. It was M. Labeyrie, the newly appointed Governor of the Bank of France and a nominee of M. Blum, who is said to have drawn the attention of several politicians, including M. Georges Bonnet, the former Finance Minister, to the far-reaching possibilities of the bill. Whether he did so because in the course of a few weeks he had come under the orthodox influence of the Bank of France, or simply because the pedantic mind of a Conseiller d'État revolted against such an untidy compromise, is difficult to say. However it may be,

the protest of M. Bonnet aroused the opposition of various groups in Parliament and the Government had to abandon its scheme. The bill was amended, fixing the exact clauses of the constitution of the Bank of France which were to be modified. The clauses determining the convertibility of the franc and its Mint parity were not amongst them. The attempt to prepare the ground for devaluation by decree failed and M. Blum had to send Parliament for the summer recess without solving the most burning problem.

CHAPTER XXIX

PROLONGING THE AGONY

(1) An Unenviable Task

Although the devaluationary campaign of former orthodox quarters and the anti-devaluationary campaign of the Communists was largely to blame for unnecessarily prolonging the defence of the franc, it would be idle to minimise the responsibility of MM. Blum and Auriol for their absurd attempt at squaring the circle. Their unwillingness to resort to the obvious and natural solution of the deadlock at the earliest possible moment carried, however, its own punishment. It was by no means an enviable task for them to bear the self-imposed burden of their unreasonable monetary policy. M. Auriol, at any rate, appeared to have actually believed in the possibility of defending the franc—an instance to prove that at times ignorance is bliss. M. Blum himself was, however, fully aware that he was fighting for a hopeless cause, and that all efforts and sacrifices to that end were utterly wasted. As may well be imagined, he did not enjoy his task.

At the outset the new Government wanted to present to the nation an inventory of conditions which it took over from its predecessor. This was considered desirable in order to avoid being blamed afterwards for what was the fault of previous Governments. On the other hand, from the point of view of the defence of the franc, the disclosure of the real state of affairs appeared anything but desirable, since it was calculated to increase the wave of distrust. After postponing several times the much-expected statement, M. Auriol elaborated a compromise between the two conflicting considerations. He told the Chamber the truth, but not the whole truth. Even what he did tell was ample to accentuate the existing pessimism regarding the prospects of the franc.

(2) Exit M. Tannery

For a long time past it had been whispered that the item of discounts in the Bank of France return included a large and increasing proportion of Treasury bills. Nobody knew,

however, what the approximate amount of concealed inflationary borrowing of the Treasury from the Central Bank was. M. Auriol announced in June that the amount was 14 milliard francs. Arrangements were made to transfer this amount from the item of Discounts to a new item called "Regularisation of Old Advances". At the same time the Treasury obtained powers to borrow from the Bank of France to the amount of 10 milliard francs. Thus while past "sins" against the causes of sound finance were ruthlessly denounced, arrangements were made for future "sinning" to take place in a legalised form. Moreover, there was nothing to prevent the Government, in addition to borrowing openly from the Bank of France, from rediscounting Treasury bills indirectly through the intermediary of the banks, just as its predecessors had. The road to inflation was well open.

One of the first acts of the new Government was to assume control of the Bank of France. To that end M. Tannery was replaced by M. Labeyrie as Governor of the Bank. Few tears were shed outside orthodox circles at M. Tannery's departure. He will go down to posterity as the man who was appointed by M. Flandin to pursue a progressive policy and who thereupon joined forces with the reactionary element in the Bank of France to defeat M. Flandin. This experience taught M. Blum a lesson. He realised that a change in personnel was in itself not sufficient to secure a change in the bank's policy. Even though the legislation enabling the Treasury to borrow openly from the bank curbed the latter's power to dictate to the Government, M. Blum and his advisers considered it expedient to make permanent provision securing the Government's control over the Central Bank. In any case, the necessity for the change of the feudalistic statutes of the bank was almost generally admitted.

Although most of the senior officials of the Bank of France had before the advent of the Socialist Government supported the reactionary policy pursued by M. Tannery and the Regents of the Bank of France, they were none the less retained by the new régime. There was one inevitable exception, and that was M. Lacour-Gayet. As I have already pointed out earlier in this book, he was the moving spirit of the deflationist group. His real influence was for years entirely out of proportion with the comparatively modest post he held. Indeed, on various occasions—especially during M. Laval's régime in 1931–2 and also during 1935–6—he was evidently the "power behind the throne". Some months after M. Tannery's resignation his

hour also struck. Metaphorically speaking, he was reduced to the ranks. Having begun his career as an *Inspecteur de finances*, he had to return to that post. The man who made financial history by inspiring M. Laval's attitude towards Germany, Great Britain, and the United States is now touring the provinces, busily engaged in the useful, though somewhat uninspiring, occupation of inspecting financial accounts and dreaming, doubtless, of the return of the old régime, which would unquestionably restore him to prominence.

(3) End of an Anachronism

A law was passed in June abolishing in the first place the supremacy of the " 200 families " by enabling all shareholders to attend the meetings of the bank and to vote. The Regency council was also abolished and was replaced by a committee on which various economic interests, including the Trades Unions, were represented. The Government retained the controlling vote, so that in practice the economic interests concerned were to act only in an advisory capacity; for all practical purposes the Bank of France was converted into a State bank.

The reinforcement of Government control over the Central Bank was in keeping with the general trend. Independent Central Banking had justification as a phase in historical development during a period when intervention was the exception and not the rule. With the passing of the automatic gold standard and the development of a managed currency —whether based on gold or not—the rôle of Central Banks has become much more important and more active. The principle that the management of the monetary policy of a country can be left in the hands of a small group of financiers could no longer be accepted. It was inevitable that the Government should assume full responsibility for the activities of the Central Bank and that the latter should thus cease to be a state within the State. In the particular instance of France, the clique which was in charge of the management of the Bank of France had fully earned its summary dismissal by the new Government. There is no need for one to be a Communist, or even a Socialist, to condemn the attitude taken up by the Regents and senior executive officials of the Bank during the past two years. Their dogmatic and short-sighted policy and their systematic attempt at controlling Government and Parliament received its well-deserved punishment when their power was definitely broken. Indeed, considering

the immense damage these gentlemen had done to France, it may be said that they were let off very lightly indeed.

(4) Flight of Capital comes to a Halt

With the advent of the Socialist Government, efforts were made to reinforce the unofficial embargoes on speculative activity and on the flight of capital. Notwithstanding this the flow of funds from France continued throughout June. Apart from fears of devaluation and of anti-capitalist measures, the flight was due, in no slight degree, to the perturbed state of things brought about by the epidemic of stay-in strikes. It looked as though France was on the eve of civil war, and many people played for safety by transferring their wealth abroad. The result was a decline of the gold reserve from 57 milliard francs to 54 milliard francs. Nevertheless, in pursuance of its cheap money policy the Government had the bank rate reduced from 6 to 4 per cent during June. This was entirely against the orthodox rules, though to some extent the new Government merely followed the precedent of the otherwise highly orthodox Governments of MM. Laval and Sarraut, who also reduced the bank rate, if not during an acute flight from the franc, at any rate immediately after the flight had come to a halt and before it had become reversed.

In July the flight from the franc subsided, or it would be more correct to say that the volume of repatriations more than offset that of the new flight. This change was attributable to various factors. The repeated statements made by M. Blum's Government disclaiming any intention of devaluing had a reassuring effect, in that devaluation was no longer considered to be imminent. The cessation of stay-in strikes removed at any rate one of the main causes responsible for the flight of capital in June. New legislation compelled owners of assets abroad to declare their assets, and this tended to discourage a new flight and even to cause some repatriation.

(5) A Short-lived Respite

Above all, the advent of the Socialist Government was accompanied by a feeling of national revival of Republican France. This feeling extended even over many quarters which had reason to be politically hostile to the new Government. The psychological effect of this revival was offset in June by the bad effect of the stay-in strikes, but when that movement subsided the favourable psychological factor became evident. A number of French people abstained from sending

their funds abroad, and many of them even repatriated their funds in order to assist the new régime. Had M. Blum's Government not resorted to a series of anti-capitalist measures the degree of repatriations would probably have been much larger. As it was, during July the gold reserve increased by nearly a milliard francs. The Treasury's position also became easier, owing to the influx of seasonal receipts. The bank rate was lowered further to 3 per cent, and the Treasury wanted to take advantage of the respite to replenish its liquid resources. It opened the lists of an issue of so-called " Auriol Bonds ", the terms of which were aimed at inducing holders of hoarded notes to subscribe. The response was, however, disappointing.

The favourable indices registered during July did not continue in August. By that time the feeling of national revival had begun to wear thin, and once more the volume of new capital exports exceeded that of repatriations. The Bank of France had to give up about half of the gold it had gained in July. Threats of investigation to ascertain the names of those who held undeclared assets abroad failed to produce any noteworthy result. Conditions in the money market remained unsatisfactory. Discount rates were actually 1 per cent above the bank rate. It was as difficult as ever for the Treasury to raise funds in the open market. And since the Government admitted that it would have to borrow 17 milliard francs before the end of the year, the prospects were none too bright. It was evident that the only source from which most of that amount could come was the Bank of France.

(6) Prolonging the Agony

If M. Auriol entertained any illusions in June and July that under the new régime the flight of capital could be checked and repatriations on a large scale could be enforced, during August he had ample reason to realise that his optimism was unjustified. Indeed, it required an unwarranted degree of optimism to suppose that the French Government would be able to compel French holders to repatriate their foreign assets. In Germany the non-declaration of foreign assets constitutes an act of economic treason subject to the death penalty. In spite of that, the Government has been unable to seize more than a fraction of the large German balances abroad. It was hardly conceivable that in democratic France, with its much less disciplined population and much less drastic

methods, the Government would be able to succeed where the German Government had failed.

Evidently the Government, in continuing to experiment with various methods to save the franc, was merely prolonging the agony. There could be no doubt about the ultimate outcome. As I pointed out in previous chapters, M. Blum himself was well aware of this, but for political reasons he was unable to make up his mind to devalue at that stage. In the absence of any sweeping pressure it would indeed have been difficult to justify such an act before the public. It was only when the lull in the crisis of the franc during July and August was followed by a fresh outburst of panic in September that M. Blum felt justified in terminating the hopeless struggle and devalued the franc.

CHAPTER XXX

THE DEVALUATION OF THE FRANC

(1) The Last Weeks of the Poincaré Franc

At the beginning of September 1936 it looked as though the French authorities had entrenched themselves to face a prolonged siege in the course of the battle of the franc. During July and August the flight of capital was much less acute than during the previous months, and to a large degree it was offset by repatriations due in part to fears of the penalties imposed by the new legislation and in part to internal requirements. The unofficial embargoes on speculative forward operations and on the flight of capital were effective to a reasonable degree. It was conceivable that they might be reinforced by legislation and that France might adopt a régime of exchange restrictions similar to those prevailing in Germany. Notwithstanding the recent gold losses, the technical position of the franc was still strong, and it appeared as though it might be many months before the adverse pressure would weaken its resistance to such an extent as to necessitate immediate devaluation or the suspension of the gold standard. Even those who realised how utterly hopeless the resistance to devaluation was were inclined to assume that nothing would be done until Parliament met in November.

In well-informed circles it was an open secret that M. Blum had become entirely converted in favour of devaluation. The question was, however, when he would muster up sufficient courage to take the plunge, and how he would solve the problem of passing the necessary legislation. Devaluationist quarters were considerably worried about the attitude of Parliament towards devaluation. When in July M. Blum challenged M. Reynaud as to whether the latter would care to introduce a devaluation bill, the reply was in the negative. There could be no doubt that the bill would have been rejected by a great majority, and the task of carrying through the devaluation would then have become even more difficult. It was feared in quarters favouring devaluation that, owing to the impossibility of obtaining a majority in Parliament in favour of

devaluation, it might be necessary to allow the technical position of the franc to deteriorate in the course of time to such an extent as to make devaluation or the suspension of the gold standard absolutely inevitable. The franc would have to be held until it was actually swept off its parity.

(2) Solutions Suggested

Various formulæ were suggested to get over the difficulty caused by Parliament's attitude towards the problem. It was suggested that while in law the old parity should be retained, in practice the conversion of francs into gold should be made very difficult. This was actually done in Great Britain during the war, when legally the Bank of England notes were convertible into gold but in practice those who attempted to convert were usually dissuaded from doing so. In France, too, various methods of discouraging withdrawals of gold were from time to time adopted, so that their reinforcement was a mere matter of degree. It was also suggested that the Government should impose an export duty on gold—it was entitled to do so under the existing legislation—thereby bringing about an external depreciation of the franc without devaluing it internally. This proposal was at one time viewed with much favour in French official circles, and there was a possibility of its adoption, on a small scale to begin with. The idea was to introduce at first a nominal export duty and then to raise it to a high percentage.

It was to the credit of M. Blum that he decided to reject these and other feeble compromises proposed, and that he preferred to choose a clear-cut solution. Credit is due to him also for finding a formula by which he was able to overcome the difficulty arising from the attitude of Parliament towards devaluation. It would have been politically impossible to ask Parliament's permission to devalue. Instead, M. Blum devalued first and consulted Parliament after.

(3) Beginning of the End

It was only towards the middle of September that talk about a possible early devaluation revived. The cause was the publication of a League of Nations report urging an adjustment of the overvalued currencies. It was widely assumed that such a resolution would not have been published without the French Government's consent, and that the document was to serve the purpose of preparing the ground for devaluation, There was also much talk about negotiations between Paris,

London and Washington. The French Government is known to have approached the British and United States Governments to induce them to conclude at least some informal understanding to avoid a currency depreciation race following upon the devaluation of the franc. Nothing was known about the result of these negotiations, but it was vaguely understood that something was happening.

In the circumstances it is not surprising that a new acute wave of pessimism regarding the future of the franc developed. This was indicated by the increase in the gold withdrawals from the Bank of France from 653 million francs during the first week of September to 840 million francs during the second week and to 2,581 million during the third week. On September 25, the gold reserve amounted to 50,111 million francs compared with 54,511 million at the end of August. There was a widespread assumption in the market that the gold reserve would not be allowed to decline below 50 milliard francs, and nervousness increased when the withdrawals brought the stock nearer and nearer to that assumed limit. It was said that the French General Staff was using all its influence to induce M. Blum to stop the drain before the resources required for the national defence became further reduced.

(4) More Hesitation

Apart from the accentuation of the flight of capital, there was also a revival of bear speculation against the franc. In face of the acute fears of devaluation, the unofficial embargoes on speculative forward operations and on the flight of capital proved to be entirely ineffective. The discount on the forward franc widened once more to fantastic dimensions. The Bank of France raised its discount rate from 3 to 5 per cent, but this was of course unable to check the drain or discourage speculation.

Notwithstanding these danger signals, the general view was that devaluation would not come until late in the autumn. After so many false alarms, many people began to doubt if the long-predicted devaluation would come after all. Many foreign holders of French assets, having spent a small fortune on hedging against devaluation for more than a year, decided not to renew the hedge this time. Others hedged against devaluation of the franc by selling guilders forward for six months, in order to be on the safe side. Thus in spite of the acute wave of pessimism, the market as a whole was far from prepared for an imminent decision.

The Government itself was divided as to whether to devalue or not. The Communists declared themselves to be as strongly opposed to devaluation as ever, but M. Blum had no longer the same reason to abide by their wishes as he had thought he had in June. In the meantime he had had all the most urgent social reform measures passed and it had become necessary in any case to call a halt in the execution of the Socialist programme, owing to the reluctance of the Right Wing of the Radical Socialist party to go much further. Moreover, developments in Spain went a long way towards inducing the French Communists to stand by M. Blum irrespective of what he did regarding devaluation. In any case, the continued resistance to devaluation was so evidently detrimental to the strength of France that Moscow must have used its influence with the French Communists to weaken their opposition to devaluation in the interests of the political and military strength of her ally.

(5) Devaluation at Last!

On September 26, five years, almost to the day, after the suspension of the gold standard in Great Britain, the French Government announced its decision regarding the franc. The convertibility of the franc into gold was suspended and an official embargo was placed on private gold export. The gold content of the franc, which had been fixed at 65½ milligrammes in 1928, was reduced within the limits of 43 and 49 milligrammes of gold, equivalent to a devaluation by between about 25 and 34½ per cent. After prolonged and desperate resistance to overwhelming influences, the French authorities capitulated and the franc was devalued.

The devaluation of the franc was beyond doubt one of the most dramatic events in financial history. The crisis that preceded it was not so sweeping as those which culminated in the suspension of the gold standard in Great Britain or in the United States. Both sterling and the dollar yielded to a violent attack which developed in the course of a few weeks. The resistance of the franc was broken by a prolonged pressure extending over a period of sixteen months. From this point of view the fall of the franc may not have been as dramatic as that of sterling or the dollar. Its fate, like that of the two other major currencies, contained nevertheless the elements of classical tragedy, in which the hero has to fall, since, even though his character and aims are noble, they come into conflict with the supreme public interest. The defence of a

currency at its existing parity was in accordance with the old-established principles of commercial integrity. Nevertheless, its failure was not only inevitable but even desirable, because it came into conflict with the major requirement of restoring equilibrium. The conflict between these requirements and the consideration of commercial integrity which inspired, in theory at any rate, the defence of the franc was not a conflict between right and wrong but between two rights. Therein lies the tragedy of the franc devaluation.

The day of September 26, 1936, constitutes a very important landmark in financial history, not only because in an important group of countries it marked the end of the resistance to reflation through devaluation, but also because it witnessed the conclusion of the Tripartite Agreement. However informal and elastic that agreement may have been, it opened a new chapter in the evolution of international monetary relations. Before proceeding with the examination of the consequences to France and other countries of the devaluation of the franc it will be necessary to examine the events and arguments that led to the conclusion of the Tripartite Agreement.

PART VI
THE TRIPARTITE AGREEMENT

CHAPTER XXXI

THE CONTROVERSY AROUND STABILISATION

(1) "STABILISATION OFFENSIVES"

THE conclusion of the Tripartite Agreement was the result of the untiring efforts of those quarters in favour of re-stabilising the world's currencies. Ever since the suspension of the gold standard in Great Britain there has been a lively world-wide controversy about the wisdom or unwisdom of returning to the régime of rigid stability. During the period between September 1931 and the suspension of the gold standard in the United States in April 1933 the barrage of the stabilisation offensive was directed against the British Government's unwillingness to re-stabilise sterling. From the suspension of the gold standard in the United States for about two years, the United States Administration shared with the British Government the rôle of the "villain of the piece", at any rate in the eyes of the stabilisationist camp. From the time of Mr. Morgenthau's statement in favour of stabilisation in May 1935, until the time of writing, the British Government was once more the sole subject of pressure by those at home and abroad who were in favour of immediate stabilisation. The controversy has been lively and at times bitter. It has been particularly acute since the first Gold Bloc crisis after the devaluation of the belga. A historical account of the financial developments of 1935–7, and of the conclusion of the Tripartite Agreement, would therefore be incomplete without dealing with this interesting controversy.

One of the reasons why the stabilisation offensive became more acute after 1935 was the relative stability of sterling. Between September 1931 and March 1935 sterling was from time to time subject to strong adverse pressure, and the Exchange Equalisation Account was obviously unable to resist it altogether. In such circumstances it was difficult to argue in favour of stabilisation, as the risk of exposing British trade to the adverse consequences of an international pressure on sterling under the gold standard was only too evident. Having had ample experience of the disadvantages

of a vulnerable sterling, official opinion, public opinion and a large section of expert opinion was hardly likely to allow itself to be induced to stabilise in circumstances which provided no safeguard against the recurrence of conditions prevailing between 1925 and 1931.

(2) Bank of England's Attitude

After March 1935, however, the Exchange Equalisation Account was able to maintain sterling relatively stable without any undue effort. Indeed, it had to confine its activities almost all the time to defending sterling against unwanted appreciation. In the circumstances the disadvantages of returning to the gold standard became less evident, and the stabilisation offensive stood a better chance of meeting with widespread response. The main strongholds of the stabilisation movement in Great Britain were the Bank of England, the London School of Economics and the Sound Currency Association.

The Bank of England is known from the very outset to have been in favour of an early re-stabilisation. Its opposition to the Treasury's contrary policy, although it has taken place behind the scenes, has been an open secret. It would be contrary to the traditions of the Bank of England to express views criticising the Government's policy, but implied and indirect criticism has been directed against it none the less by means of the periodical statements issued by the Board of Directors of the Bank for International Settlements, which, as is well known, includes Mr. Montagu Norman and Sir Otto Niemeyer. Although Mr. Montagu Norman's influence on the Treasury is nothing like as great as before the crisis, his strong personality has remained a factor to be reckoned with. Mr. Norman must have realised that, in face of the Government's determination not to stabilise for the time being, his attitude in favour of stabilisation was of no avail. Nevertheless, he remained faithful to the idea of stabilisation at the earliest possible opportunity. Even though he was hardly in a position to work actively in favour of immediate stabilisation, the trend of occasional articles in the City sections of newspapers deriving inspiration from the Bank of England showed all along that he did not by any means give up hope of influencing the official monetary policy in the desired direction.

(3) London School of Economics and Sound Currency Association

The London School of Economics and Political Science has always been the spearhead in the academic field of the movement in favour of an orthodox monetary policy. Indeed, there is a remarkable contrast between the radicalism of the political section of that School and the reactionary tendencies of its economic section. It will be remembered that soon after the war Professor Cannan went so far in his deflationary zeal as to start a legal action against the Treasury for profiteering on the ground that it was selling for ten shillings or a pound bits of printed paper worth a fraction of a farthing. It is in accordance with the traditions of that School that it should provide the theoretical ammunition for the fight in favour of immediate stabilisation. Professor Hayek, inspired by a dislike for any departure from orthodoxy that originated during the disastrous inflationary period in Austria, has infused fresh blood into the School. With Professors Gregory and Robbins, he has constituted a trio which is a factor of importance in the controversy. Between them they set up a cult of the Austrian economist, Professor Ludwig von Mises, with his fanatic belief in cutting down prices, and especially wages, as a remedy for all evil.

The Sound Currency Association was for years moribund; for with the stabilisation of sterling at its pre-war parity in 1925 it achieved its main object. Although its various supporters never ceased to agitate between 1925 and 1931 in favour of reducing the fiduciary issue, they stirred up but little interest. The Association was revived recently by its originator, Mr. D. M. Mason, ex-M.P., who never missed an opportunity in the House of Commons of impressing upon the Government the necessity for immediate stabilisation. The fact that the chairman of one of the Big Five has joined the Association shows that it does not lack support in influential banking circles. Another organisation which works in the same direction but which is less known is the "Friends of Economy" movement; it suffered a severe reverse through the disappearance of *The Independent*, a weekly paper established by Sir Ernest Benn for the purpose of supporting orthodox ideas in the sphere of monetary, financial and economic policy. The Sound Currency Association itself suffered a reverse when at the Election of 1935 Mr. Mason failed to be re-elected. Nevertheless, it continued its active stabilisation propaganda.

(4) Bankers, City Editors and Politicians

In addition to the systematic efforts of these institutions, the movement in favour of stabilisation has received support from time to time from various bankers and business men, in the form of public statements urging an immediate return to gold. The frequency of such statements at shareholders' meetings or at various City banquets has conveyed the impression that opinion in the City is practically unanimous and in favour of immediate stabilisation. This is not the case. A large proportion of leading bankers and City men are opposed to it, but they are reluctant to express their opinion in public. On the other hand, those in favour of the orthodox policy never miss an opportunity for doing so. In some cases, at any rate, an emphatic declaration made at a shareholders' meeting urging the necessity of immediate stabilisation has served the useful purpose of diverting attention from the weak points of the balance-sheets. Since the majority of City editors are in favour of early stabilisation, the financiers concerned were certain to secure for themselves a favourable Press on the basis of their " sound " views, even though there was nothing else sound in their annual reports. It never occurs to anybody to ask whether these financiers, having mismanaged the affairs of their own companies, were qualified to advise the Government and the public on the management of the affairs of the country.

On the rare occasions when the Government's monetary policy has been put to the vote in the House of Commons there has invariably been a large majority in favour of it. Nevertheless, among politicians the idea of immediate stabilisation has received frequent support, especially on the part of the Liberal opposition ; though the Labour opposition has been definitely against it, there are exceptions.

All these quarters have been in favour of stabilising sterling unconditionally at the earliest possible moment. There are many others who are in favour of an early stabilisation subject to certain reserves and qualifications, either regarding the general conditions in which stabilisation is admissible or regarding the limitations of the proposed new stable monetary system.

(5) Opponents of Stabilisation

At the opposite extreme there are those who are determined opponents of stabilising sterling. They demand the complete

demonetisation of gold and the permanent establishment of a scientifically managed inconvertible paper currency. In addition to the endless variety of radical currency reformers, this camp included among others, Lord Beaverbrook, although lately he has been wavering in his opposition to gold and to stabilisation. This camp again includes a number of moderates who are in favour of returning to a limited gold standard. The difference between them and the moderates of the stabilisationist camp is at times hardly recognisable. Indeed, some well-known experts are sometimes in one camp and sometimes in the other.

Between those who are in favour of an early stabilisation and those who are against stabilisation in relation to gold at any time there is the intermediate camp favouring stabilisation at some future unspecified time. Mr. Neville Chamberlain himself and most Treasury officials belong to that camp. It has gained adherents also among economists and bankers, and even among Financial Editors.

(6) The Stabilisationist Movement in the United States

In the United States the movement in favour of an early return to gold has been distinctly stronger than in Great Britain. For one thing, since January 30, 1934, there has been provisional stabilisation in force, without any adverse consequences. Moreover, the dollar has been all the time evidently undervalued in relation to practically every currency, and the United States has a huge and increasing gold stock. In the circumstances it is not surprising that even in official quarters there are adherents to early stabilisation. Mr. Morgenthau, the Secretary of the Treasury, has repeatedly declared himself in favour, but President Roosevelt himself is less anxious to relinquish the freedom of the dollar. The orthodox economists such as Professor Sprague, Professor Kemmerer, and others play the same part as the Professors of the London School of Economics do in England. Bankers in the United States are even more universally and openly in favour of stabilisation than in England. In political quarters, however, the idea is less popular, and during the electoral campaign the proposal that stabilisation should form part of the Republican programme was rejected.

The extreme opponents of stabilisation in the United States are even more numerous than in England. They include, of course, such extreme monetary reformers as Dr. Townsend, Father Coughlin, etc. Between the two extremes there is a

school which regards stabilisation as the ultimate end, but is in no hurry to achieve it. This camp includes President Roosevelt himself and a number of economists.

(7) International Institutes favour Stabilisation

Outside the United States and Great Britain the majority of expert opinion distinctly favours early stabilisation. Official as well as unofficial quarters in various continental countries have left no stone unturned to induce the British and United States Governments to agree to stabilisation. From time to time stabilisation offensives are launched from the continent and especially from France. The International Chamber of Commerce in particular has become one of the headquarters of the stabilisation movement. It formed a joint committee with the Carnegie Endowment to produce a report in two volumes in which most contributors aimed at making out the strongest possible case for immediate stabilisation. As we said above, the Bank for International Settlements at Basle is another international headquarters for the stabilisationist movement, which is also supported actively by the economic and financial committees of the League of Nations.

In the following three chapters I have endeavoured to give an outline of the French, American and British attitude towards stabilisation, such as it was during the period between the devaluation of the belga in March 1935 and the collapse of the Gold Bloc in September 1936. The attitude of the Governments of the three countries is worth studying in the light of the subsequent conclusion of the Tripartite Agreement simultaneously with the devaluation of the franc.

CHAPTER XXXII

THE FRENCH ATTITUDE TOWARDS STABILISATION

(1) Deflation for its own Sake

It goes without saying that pressure in favour of stabilisation was strongest on the part of France. Both anti-devaluationists and devaluationists were united in their wish to see sterling and the dollar stabilised at the earliest possible moment. This desire frequently found expression even in official quarters, although in face of the declared British official policy not to stabilise for the time being, it amounted to interference with the monetary policy of another nation. The French Press was always indignant when entirely unofficial British quarters expressed their view that the franc should be devalued. They themselves never hesitated, however, to urge Great Britain to stabilise sterling and considered it only natural that even members of the Government, and Governors of the Bank of France, should voice this opinion in the face of the declared British official policy to the contrary.

It is easy to understand the strong desire on the part of French anti-devaluationists to obtain the stabilisation of sterling and the dollar. If they had had their way, both currencies would have been stabilised at their old parities in relation to the franc. Since, however, they had sufficient sense of reality to know that such a demand would be sheer waste of effort, the next best thing, from their point of view, was to advocate the stabilisation of sterling and the dollar at their existing depreciated level. Admittedly this would have perpetuated the overvaluation of the franc, unless and until its disequilibrium was removed by means of deflation. But then, deflation, in the eyes of many anti-devaluationists, was not something to be afraid of; it was not even a necessary evil, but something desirable for its own sake.

(2) Misguided Puritanism

Incredible as it may sound that anyone should care deliberately to inflict upon a nation the inconveniences and suffering inevitably associated with deflation, there is no need to go

according to which poverty is the highest of virtues, and any advancement of mankind from the bare subsistence level towards prosperity is highly immoral and sinful, punishable with hell fire. Permanent poverty should be the destiny of mankind in this vale of sorrows, in the hope of reward for virtue in the next world. This school denounces even the slightest departure from the very deepest point of depression as " inflationary boom ", which has to be checked by ruthless methods of deflation.

There is, however, another motive which prompts some of the professional deflationists. They derive a sadistic pleasure from inflicting suffering upon others, while they themselves are sheltered by their professorial salaries. Indeed, it is difficult to find the borderline between these motives and those of misguided Puritanism.

(3) Attitude of French Stabilisationists

As far as France is concerned there is in addition another motive which is absent in Anglo-Saxon countries. It is the fundamentally parsimonious character of the French people. For some odd reason the French nation has acquired a reputation for being a nation of spendthrifts. Nothing could be further from the truth. The average Frenchman is probably the most economical of all men, and deflation is therefore in accordance with his fundamental character. It is thus no wonder that the idea that, by stabilising sterling and the dollar at their undervalued level, the overvaluation of the franc in relation to those currencies should be fixed, and should be removed subsequently by deflationary efforts, appealed to some of the French experts.

But even the French devaluationists were anxious that some sort of stabilisation should be arranged simultaneously with the devaluation of the franc. They were afraid that, should

the devaluation of the franc be followed by a further depreciation of sterling and the dollar, this would wipe out its beneficial effects upon the franc. Most French devaluationists attached more importance to the restoration of the international equilibrium of the franc than to the restoration of the internal equilibrium between the national income and the burden of fictitious indebtedness. Hence their fears of a depreciation race, even though it might have proved a blessing in disguise by leading to the restoration of the internal equilibrium. The fear of the possibility of such developments was so intense that when it was reported in Paris early in 1936 that the British Government had decided to depreciate sterling further if the franc was to be devalued, even M. Paul Reynaud admitted that this would destroy his case in favour of devaluation. Needless to say, the report was sheer invention and was deliberately launched into circulation in Paris by certain anti-devaluationist quarters. It secured for the opponents of devaluation a short-lived triumph, since it induced several prominent politicians—M. Herriot among others—to declare themselves emphatically against devaluation, and this strengthened for a while the position of the anti-devaluationist camp.

(4) An Ingenious Formula

During the crisis of May and June 1935, some formerly orthodox quarters were also inclined to agree to devaluation provided that it took place simultaneously with international stabilisation. The ingenious formula was put forward that while France would not think of allowing speculators to sweep the franc off its old parity, she was willing to do her bit towards the restoration of international equilibrium by devaluing the franc as part of an international agreement. How those responsible for this formula imagined that the franc would remain immune from speculative attack while an international conference discussed the degree of its devaluation is past understanding. Subsequently the formula was dropped and it was declared that devaluation was entirely a national question and could not be subject to the decisions of international conferences.

In any case, when M. Laval's deflationary measures temporarily restored confidence in the franc, the suggestion that it should be devalued as part of an international stabilisation scheme was dropped, and the Puritano-sadistic conception of restoring equilibrium by ruthless deflation gained the upper hand. It was not until the next crisis of the franc that the

idea of devaluation simultaneously with stabilisation abroad was revived, only to be dropped as soon as the attack subsided. Every time the franc succeeded in getting over one of its periodical attacks, this resulted in a wave of optimism, and it was widely believed that, having got over this attack, the franc would hold its own for ever. In such circumstances it was difficult to discuss devaluation, even as part of a general *scheme of stabilisation.*

From time to time British and American quarters were sounded unofficially to ascertain their attitude towards a French devaluation. The British reply was invariably that, while in itself a reasonable degree of devaluation would not be followed by any deliberate downward adjustment of sterling, if it should lead to an adverse pressure on sterling the Government reserved its freedom to allow the exchange to find its level.

(5) "ALIGNMENT" *v.* DEVALUATION

The American attitude was that, should sterling depreciate after the devaluation of the franc, President Roosevelt would certainly make use of his right to lower the value of the dollar further. These replies did not satisfy the French Government. It was felt in political circles in Paris that the devaluation of the franc could only be made palatable to the French public if it were to form part of an international stabilisation scheme, however informal and provisional that scheme might be. It came to be regarded as a matter of prestige that the franc should be adjusted to a new parity only simultaneously with an all-round international monetary adjustment. Indeed, the very word "devaluation" was taboo in the discussion of the problem by French politicians and in the French Press. The word "alignment" was specially invented to avoid their having to refer to devaluation. No progress was made, however, towards persuading Great Britain and the United States to be party to such international alignment of currencies.

Throughout 1935 and 1936, official quarters missed no opportunity for emphasising the necessity for international stabilisation. The British Government's unwillingness to stabilise sterling was subject to criticism even in official French quarters, while former Cabinet Ministers such as MM. Germain Martin and Bonnet took a particularly active part in the stabilisation offensives launched from time to time. With the adoption of sanctions against Italy, these stabilisation offensives subsided to some extent, since Mr. Chamberlain made it

quite plain that in the existing conditions of international political uncertainty the question could not even be considered.

(6) M. Blum's Negotiations

After the Socialist victory at the General Election, a number of French experts adopted the view that the franc should be devalued immediately, irrespective of what other countries chose to do. This view was not shared by the Government, nor even by M. Blum and those members of the Cabinet who were in favour of devaluation. They lost no time in getting in touch with London and Washington to negotiate some form of *de facto* stabilisation in order to facilitate the task of devaluing the franc. The French negotiators emphasised in London that in the absence of an international understanding the resistance to the devaluation of the franc would have to continue, and this would inevitably weaken the international political position of France. By that time the British Government was fully alive to the German menace and to the necessity for a strong and united France. It became increasingly evident throughout the summer of 1936 that prolonged resistance to devaluation would sooner or later lead to revolution and civil war in France. It was probably this political consideration more than anything else that eventually induced the British Government to agree to the informal understanding concluded in September between the three leading countries.

In these negotiations M. Paul Reynaud played an important part. He paid a visit to London, and took advantage of the occasion of the Harvard centenary celebrations to pay a visit to the United States. In an unofficial capacity he negotiated with the British and United States authorities and paved the way for the official negotiations leading to the conclusion of the gentlemen's agreement in September. As we shall see in Chapter XXXV, that agreement does not amount to anything like stabilisation, but it could be presented as such. It was sufficient to save the French Government's face and enable them to mitigate opposition to the devaluation of the franc.

(7) The Rate of Devaluation

Regarding the rate of stabilisation, the French attitude was characterised all along by a high degree of orthodoxy. The view was already held in official circles that the percentage of the inevitable cut in the value of the franc should be kept as low as possible. Many of those who did not believe that M. Laval's deflationary measures would in the long run obviate

the necessity for devaluation were in favour of the all-round cuts because in their opinion it would reduce the extent to which the franc would have to be devalued. It was believed at that time that a devaluation of about 15 per cent would be sufficient. When, however, it became evident that the deflationary measures had failed to produce the desired effect, the estimates regarding the necessary degree of devaluation were gradually revised in an upward direction. Early in 1936 the figure of 20 to 25 per cent was the popular forecast.

After the advent of the Socialist régime, the view was held that the level at which the franc would be stabilised would be at least 35 per cent below its old parity. Official quarters did not, however, accept this estimate, and, as we shall see later, 35 per cent was accepted as the maximum and not the minimum degree of devaluation, while the actual rate was 30 per cent only. Even that figure was considered excessive in official circles in London and Washington, and it took some effort by the French authorities to persuade them to allow the franc some slight margin in anticipation of a rise in French wages and prices.

CHAPTER XXXIII

THE AMERICAN ATTITUDE TOWARDS STABILISATION

(1) Deliberate Depreciation of the Dollar

Before the suspension of the gold standard in the United States, the Washington Administration was strongly in favour of the stabilisation of sterling. President Hoover is known to have been prepared to attempt to induce Congress to agree to a renewal of the moratorium on war debts provided that in return the British Government was prepared to return to the gold standard. After the suspension of the gold standard in the United States, however, it was Washington's turn to pursue an anti-stabilisation policy. In fact, it was President Roosevelt's message to the Economic Conference on July 5, 1933, that wrecked the attempt at an international currency agreement. President Roosevelt felt at that time that the dollar had not yet found its level, and he was therefore not prepared to stabilise. During the following autumn and winter, he deliberately depreciated the dollar to a level which he regarded as sufficiently low for his purpose.

On January 30, 1934, the dollar was provisionally stabilised at 59 per cent of its old parity, although the President reserved the right to change its value by administrative action between 50 and 60 per cent. The fact that he reserved the right to devalue the dollar by a further 9 per cent of the old parity showed, however, that he was anything but keen on definite stabilisation. To some extent the right to devalue the dollar once more was reserved as a weapon in an international currency depreciation race, or as a bargaining counter in an international currency agreement. But to a very large extent President Roosevelt wanted to reserve the right to depreciate the dollar further as a means of accentuating reflation in the United States. The extent of American trade revival in 1934 was limited, and the President was not sure whether he ought not to resort to further drastic measures to accentuate it.

(2) Mr. Morgenthau's Move

In May 1935 Mr. Morgenthau made a statement which, in so far as it could be taken at its face value, indicated a change in the American monetary policy. He declared himself emphatically in favour of immediate and definite stabilisation provided that Great Britain was prepared to do the same. The world was threatened with a further depreciation of the dollar should any other major currency be allowed to depreciate. This statement was subsequently reaffirmed by Mr. Morgenthau on more than one occasion. Notwithstanding its emphatic character, there is good reason to doubt whether the Washington Administration was really so keen on stabilising as Mr. Morgenthau wanted to make it appear. Indeed, in a statement made at a later date by President Roosevelt himself, the views expressed were strongly in conflict with those of Mr. Morgenthau. Discussing the various " patent remedies " proposed by various currency cranks, President Roosevelt mentioned the return to gold amongst them. Obviously he was anything but keen on a definite stabilisation of the dollar.

Why, then, was it that Mr. Morgenthau made it appear that the one great wish of the Washington Administration was to return to gold? It was largely in order to shift all responsibility for the prolonged instability of currencies to the British Government. Had Mr. Morgenthau had any reason to suppose that London was willing to stabilise, he would not have dared to come out with a definite statement in favour of immediate stabilisation, for he might easily have been taken at his word, which would have been most embarrassing. As it was, he knew he was quite safe in urging stabilisation, because London was definitely against it.

Admittedly, as time went on it became less and less likely that President Roosevelt would make use of his right to devalue the dollar to 50 cents unless there was a depreciation of sterling. The progress of trade revival during 1935 and 1936 made the necessity for further devaluation less evident. In spite of this, President Roosevelt was not prepared to relinquish his right to devalue. Apart from international considerations, the approaching Presidential Election made it inexpedient to resort to such an orthodox measure as stabilisation. Possibly he might have won a few Conservative votes by returning to gold, but on the other hand he would have run the risk of losing millions of votes in favour of the extremist candidates, who would then have accused him of serving the interests of

bankers and international financiers at the expense of industry and agriculture. The informal agreement of September 1936 was about the limit to which President Roosevelt was prepared to go before the Election. Had Great Britain been prepared to return to gold on condition that the United States stabilised at the same time, President Roosevelt would certainly not have wanted to be a party to such an agreement.

(3) Desire to Undervalue Dollar

While the French view regarding the rate of stabilisation of the franc was inclined to err on the orthodox side, the American attitude was in favour of perpetuating the undervaluation of the dollar. No criticism of this attitude can be too severe. It discloses a degree of short-sightedness which, so long as it persists, precludes the possibility of genuine international co-operation. In this respect, Mr. Morgenthau is to be regarded as the " villain of the piece ", though his policy is but a continuation of the policy taken up by the United States ever since the war, an attitude which was largely responsible for the crisis of 1931. When, as a result of the war, Europe contracted heavy indebtedness towards the United States, and the latter became a large creditor country, it was essential that payment should be accepted in goods. The United States, however, checked the import of goods by prohibitive tariffs, and maintained a favourable trade balance. As a result, she accumulated an excessive volume of gold at a time when maldistribution of the world's gold supplies was beginning to assume increasing importance as a factor threatening international stability. In addition, the unwillingness of the United States to accept goods and the inability of the debtor countries to pay in gold led to a rapid increase of the world's indebtedness to the United States. A large part of this indebtedness assumed the character of floating debts. It was the sudden withdrawal of American short-term credits to Central Europe that provided the direct cause for the collapse of 1931.

Mr. Morgenthau and the supporters of his policy appear to have learned absolutely nothing from this experience. They continue to aim at maintaining an export surplus and to repatriate this surplus in the form of gold. As Mr. Morgenthau put it in one of his statements, the level at which the dollar was stabilised must be such as to secure to the United States a fair proportion of the world's trade and of the world's gold supply. When this rule was established, the United States'

gold stock was approaching 10 milliard dollars. It is a pity Mr. Morgenthau did not make it plain how many more milliards he considered to be the fair share of the United States. What is worse, while during the period before 1931 the United States was at least prepared to lend abroad, at present she is not prepared to do so, so that the whole of her trade surplus *and debts service* payments must necessarily lead to a further influx of gold.

(4) To prevent Undervaluation of Sterling

It was in order to secure the continuity of the inflow of gold that Mr. Morgenthau insisted upon the stabilisation of the dollar at an undervalued level. While the French Government was anxious that the franc should not be stabilised at a lower level than was absolutely indispensable, the United States Administration was equally anxious that the dollar should be stabilised at a level at which it would stimulate American exports and the influx of gold.

While to a large extent Mr. Morgenthau's policy in this respect is but the continuation of the American post-war attitude, to some extent it is inspired by the traditional distrust felt in the United States towards British policy. For some inscrutable reason, British statesmen, diplomats and financiers are regarded on the other side of the Atlantic as essentially shrewd and subtle, capable of getting the better of any bargain with the United States. As between 1931 and 1933 American trade lost ground in favour of British trade as a result of the depreciation and undervaluation of sterling, the American authorities are determined to avoid at all costs a recurrence of such a situation. And since it is impossible to calculate with certainty the rate which represents the equilibrium level between sterling and the dollar, the United States would prefer to err on the safe side by allowing a margin of undervaluation in favour of the dollar.

In May 1935, Mr. Morgenthau appeared to be opposed even to a devaluation of the franc, notwithstanding the fact that the franc was obviously overvalued even in relation to sterling, and much more so in relation to the dollar. Subsequently, however, he changed his attitude in this respect and had no further objection to a devaluation of the franc provided that it was not followed by a depreciation of sterling. Both he and President Roosevelt were determined all along that, should sterling depreciate much below its old parity of 4.86, the dollar would be devalued to a level at which that parity was more or

less restored. And since the British official view was that the equilibrium level of the sterling–dollar rate was somewhere under 4.50, the rigidity of the American attitude in this respect precluded the possibility of a stabilisation agreement even if Mr. Chamberlain had been prepared to link sterling to gold.

The pressure in favour of stabilisation was not nearly so strong from the American side as from the French side. Apart from the occasional statements made by Mr. Morgenthau emphasising how willing and even eager the United States was to stabilise, there were but few attempts from American quarters to bring pressure to bear upon the British Government to change its policy. Even though the official American monetary policy was moving gradually towards orthodoxy throughout 1935 and 1936, President Roosevelt was certainly in no hurry to relinquish his freedom of action regarding the value of the dollar.

CHAPTER XXXIV

THE BRITISH ATTITUDE TOWARDS STABILISATION

(1) Turn in the Trend of Sterling in 1935

Throughout the period following 1931, France remained consistent in urging immediate international stabilisation. The attitude of the United States was, as we have seen, considerably less consistent after 1933; even from 1935 onwards, when Mr. Morgenthau declared himself in favour of immediate stabilisation, his views were obviously not shared by the whole Administration, and their sincerity was open to question. As far as Great Britain was concerned, her attitude was as consistent as that of France, but in the opposite direction. In face of pressure from France, the United States and, last but by no means least, a considerable section of British expert opinion, the Government persistently refused to consider the idea of linking sterling to gold.

Until 1935 the matter could not be considered seriously. From time to time sterling was subject to strong adverse pressure, and the Exchange Equalisation Account was compelled to allow it to depreciate considerably. The range of the fluctuations of sterling was wide, in spite of the official efforts to "iron out" speculative movements. In every year between 1931 and 1935 there was at least one major flight from the pound, leading to the depletion of the gold resources of the Exchange Equalisation Account. From March 1935 onwards, however, sterling displayed a much firmer trend. The belga crisis and the series of attacks on the Gold Bloc currencies between April 1935 and September 1936 resulted in a strong, if not altogether continuous, buying pressure on sterling. A large part of the funds which took flight from France, Switzerland and Holland found their way to London. In order to avoid an unwanted appreciation of sterling the Exchange Equalisation Account bought large amounts of gold. Obviously the task of the authorities was no longer to defend sterling against a fall but to defend it against a rise—a task which would present no material difficulties under the gold standard.

(2) Public Opinion against Stabilisation

It is not surprising that from the spring of 1935 onward the pressure on the Government in favour of stabilisation strengthened considerably. In face of strong and increasing demand from various quarters, the Government persistently refused to depart from its policy, which was to retain freedom of action. While endeavouring to keep the fluctuations within the narrowest possible limits, it was not prepared to relinquish its right to allow sterling to depreciate should a strong and persistent adverse pressure arise. It appeared at first as though the Government's refusal to link sterling to gold, or even to stabilise it without actually restoring the gold standard, was due to electoral considerations. Indeed, stabilisation would have been highly unpopular among the great masses of the electorate. While in 1925 the general public had no opinion about the wisdom or unwisdom of returning to gold, by 1935 strong public opinion had developed against stabilisation in general and premature stabilisation in particular. The man in the street realised that his welfare depended to a hitherto unsuspected degree upon the Government's decision on monetary policy. It was impossible to escape the fact that before 1931 the defence of sterling at its old parity in relation to gold was largely responsible for the comparatively high level of interest rates, and for the chronically depressed state of trade. It was equally impossible to escape the fact that, since the suspension of the gold standard, trade had improved considerably, partly because sterling had ceased to be overvalued, but also largely because considerations of the defence of sterling did not necessitate high interest rates.

It was too much to expect that the average constituent would understand the intricacies of the arguments for and against stabilisation. The fact, however, that the country has been better off since the suspension of the gold standard was sufficient to make most people oppose stabilisation. Had the Government declared itself in favour of stabilisation, it would have lost millions of votes to the Opposition, who would hardly have missed such an opportunity for making stabilisation one of the major electoral issues. Indeed, it appeared at one time as though the question of monetary policy might play an important part at the next General Election.

(3) Why Mr. Chamberlain rejected Stabilisation

As it was, the election was fought with hardly any reference to stabilisation. Since Mr. Chamberlain had made it abundantly clear before the election that he had not the least intention of linking sterling to gold for a long time to come, there was no conflict of opinion between Government and Opposition, and there was nothing to fight about. The result of the election confirmed the Government in office for another four or five years, and it was hoped or feared in many quarters that Mr. Chamberlain would now take the opportunity to stabilise at an early date, on the assumption that by the next General Election the public would have forgotten about it. He did nothing of the kind, however. He remained as firmly opposed to stabilisation as he had declared himself to be before the election—a fact which amply proved that he was sincere in his monetary policy. Thus electoral considerations can safely be ruled out from among the motives responsible for the Government's unwillingness to stabilise.

Until the autumn of 1935 the main reason why Mr. Chamberlain was unwilling to consider stabilisation was his fear that it would interfere with his cheap money policy. From the autumn of 1935 onwards the uncertainty of the international political outlook made it appear more undesirable than ever to give up the freedom of sterling. Political considerations were thus added to the economic and financial considerations against premature stabilisation.

(4) Disequilibrium within Sterling–Dollar–Franc Triangle

The economic and financial reasons why Mr. Chamberlain was unwilling to stabilise were stated repeatedly in the House of Commons and on other public occasions. Mr. Chamberlain was determined to maintain interest rates at a low level until abnormal unemployment was completely absorbed. The existing position, and still more the prospects, offered no safeguards that once sterling was stabilised its defence would not necessitate higher interest rates. Hence his determination not to place himself in a position where the advantages of a cheap money policy would have to be sacrificed for the sake of defending sterling. In his view, expressed repeatedly during 1935, there was no equilibrium within the sterling–dollar–franc triangle. While the franc was grossly overvalued in relation to sterling, the dollar was distinctly undervalued. In the cir-

cumstances he did not consider it safe to perpetuate the disequilibrium. While the Chancellor of the Exchequer and several other holders of public offices took good care not to express any opinion regarding the course the French or American monetary policy should follow, it was implied in various public statements that there could be no stabilisation of sterling unless the franc was devalued and the dollar had appreciated to its equilibrium level in relation to sterling. These implied opinions could not possibly be regarded as criticism of the French or American authorities. All Mr. Chamberlain and other British official personalities did was to state the obstacles to the stabilisation of sterling.

While Mr. Chamberlain made it quite plain that so long as the franc was overvalued and the dollar undervalued there could be no question of stabilisation, on the other hand he made no promise that as soon as this disequilibrium was removed he would stabilise forthwith. For one thing, he did not possess adequate means to ascertain the equilibrium rates of exchange, which have to be decided by a period of practical experience. This was one of the reasons why Mr. Chamberlain was not prepared to make any binding promise that he would prevent a depreciation of sterling following upon the devaluation of the franc. Whether a devaluation would merely restore equilibrium or lead to the actual overvaluation of sterling could be discovered only by at least twelve months of experience.

Apart from this, the uncertainty of the future outlook made it appear expedient to retain the freedom of sterling. The international economic and financial system was in a state of flux. Various factors were at work in various countries affecting commodity prices to a large degree. The international floating debt, though not so large as in 1931, was in 1935 still considerably above the normal and continued to constitute a potential danger to monetary stability. Last but by no means least, the uncertainty about the final settlement of the war debt problem made it also inexpedient to stabilise sterling before a definite arrangement had been reached.

(5) The Abyssinian War

All these considerations, together with trade and exchange restrictions and many other considerations, provided ample justification for Mr. Chamberlain's unwillingness to stabilise, even before the international political troubles and rearmament introduced an entirely new element into the situation. During

the autumn of 1935 the Abyssinian war and the imposition of sanctions against Italy created an atmosphere of tension. From time to time there appeared to be real danger of a European war. In such circumstances it was obviously the wrong moment to stabilise. Apart altogether from the inevitable necessity of suspending the newly-established gold standard in case of war, the possibility of war scares was in itself sufficient to discourage any desire to stabilise. Curiously enough, it was just during this period that the stabilisation offensive, both within this country and from the part of France, became intensified. Even if earlier in the year Mr. Chamberlain had had every intention of stabilising, the international political situation would in itself have been sufficient to induce him to change his mind.

In addition to this, the Mediterranean situation in the autumn and winter of 1935 revealed the necessity for speedy rearmament. It was impossible to foresee the extent of the expenditure required for that purpose, but it was evident even at that stage that for considerations of the national defence the Government would have to unbalance the Budget during a series of years. This being the case, it would have been anything but wise on the part of the Government to place itself in a position where the requirements of national defence would have come into conflict with those of the stability of sterling. One of the main reasons why, after the war, the successive British Governments disarmed to such an extent as to endanger the security of the Empire was the desire to balance the Budget in order to maintain sterling at its old parity. It would have been absurd for the British Government deliberately to impose upon itself a handicap just at that moment when it was essential to make good the gaps in the national defence irrespective of cost.

(6) Mr. Chamberlain's Dilemma

While the acute danger of a Mediterranean war subsided early in 1936, the international situation continued to give rise to concern, owing to the increasingly aggressive attitude of National-Socialist Germany. It became necessary to accelerate the pace of rearmament. By the spring of 1936 it became evident that in order to make good the omissions of the past hundreds of millions, if not milliards, of pounds, would have to be spent. In such circumstances it would have been the height of folly to link sterling to gold. The Rhineland occupation and other acts of violation of treaties by Germany,

the Italo-German alliance, the Spanish Civil War, accentuated the concern about the international outlook and made it increasingly evident that sterling would have to be kept free in order not to handicap rearmament.

At the same time, however, the progressive deterioration of the financial, economic and political strength of France and the danger of revolution in consequence of the conditions created by the stubborn defence of the franc made it politically desirable to facilitate for M. Blum the task of devaluing the franc. The French Government insisted that it was politically impossible to devalue unless the British and United States Governments agreed to some kind of informal stabilisation. The British Government was confronted with an awkward dilemma. On the one hand it had to maintain the freedom of sterling in order to be able to strengthen the national defence. On the other hand, it thought it desirable to agree to some form of stabilisation for the sake of safeguarding the strength of Great Britain's one natural and reliable ally. Torn between the two conflicting desires, London eventually agreed to the informal and provisional stabilisation brought about by the Tripartite currency agreement announced on September 26, simultaneously with the devaluation of the franc.

CHAPTER XXXV

THE TRIPARTITE AGREEMENT

(1) The Statement of September 26, 1936

How was it possible to reconcile Great Britain's determination to keep sterling free with the desire to facilitate M. Blum's task of devaluing the franc by adopting some form of stabilisation? The solution chosen would have done credit to the mediæval Pope who, being desirous of putting an end to the determinism *v.* freewill controversy, made the pronouncement that there was freewill as well as determinism, and that there was nothing more to be said about it. According to the letter and spirit of the Tripartite Agreement, sterling was to remain stable around its existing level, but at the same time it retained its freedom. This ingenious formula was embodied in the following statement issued by the British Treasury:

1. His Majesty's Government, after consultation with the United States Government and the French Government, join with them in affirming a common desire to foster those conditions which will safeguard peace and will best contribute to the restoration of order in international economic relations, and to pursue a policy which will tend to promote prosperity in the world and to promote the standard of living.

2. His Majesty's Government must, of course, in its policy towards international monetary relations, take into full account the requirements of internal prosperity of the countries of the Empire, as corresponding considerations will be taken into account by the Governments of France and of the United States of America.

They welcome this opportunity to reaffirm their purpose to continue the policy which they have pursued in the course of recent years, one constant object of which is to maintain the greatest possible equilibrium in the system of international exchanges and to avoid to the utmost extent the creation of any disturbance of that system by British monetary action.

His Majesty's Government share with the Governments of France and the United States the conviction that the continuation of this twofold policy will serve the general purpose which all Governments should pursue.

3. The French Government inform his Majesty's Government that, judging that the desired stability of the principal currencies cannot be ensured on a solid basis except after the re-establishment of a lasting equilibrium between the various economic systems, they have decided, with this object, to propose to their Parliament the readjustment of their currency. His Majesty's Government have, as also the United States Government, welcomed this decision in the hope that it will establish more solid foundations for the stability of international economic relations.

His Majesty's Government, as also the Governments of France and of the United States of America, declare their intention to continue to use the appropriate available resources so as to avoid as far as possible any disturbance of the basis of international exchanges resulting from the proposed readjustment. They will arrange for such consultation for this purpose as may prove necessary with the other two Governments and the authorised agencies.

4. His Majesty's Government are moreover convinced, as are also the Governments of France and the United States of America, that the success of the policy set forth above is linked with the development of international trade. In particular, they attach the greatest importance to action being taken without delay to relax progressively the present system of quotas and exchange controls with a view to their abolition.

5. His Majesty's Government, in common with the Governments of France and the United States of America, desire and invite the co-operation of the other nations to realise the policy laid down in the present declaration. They trust that no country will attempt to obtain an unreasonable competitive exchange advantage and thereby hamper the effort to restore more stable economic relations which it is the aim of the three Governments to promote.

(2) An Orthodox Victory

In plain English, this meant that while the three Governments undertook to refrain from competitive depreciation, and even to do their best to defend their currencies around their existing levels, they would not go so far as to sacrifice internal prosperity to the requirements of the defence of international stability. The stabilisation attained by the Tripartite Agreement was relative, informal and provisional. It was relative because no rigid parities were fixed; it was informal because each of the three Governments reserved the right to change the relative international value of its currency by administrative action; and it was provisional because the whole arrangement was on a 24-hour basis.

The announcement of the arrangement was expressed in

sufficiently vague terms for anyone to read into it whatever they wished it to mean. It was possible for M. Blum to present the agreement as the much-desired stabilisation which justified devaluation of the franc as part of an international alignment of currencies. At the same time it was possible for Mr. Chamberlain to declare that the freedom of sterling remained unimpaired by the arrangement. As for Mr. Morgenthau, he was able to get the best of both worlds by presenting the arrangement as making for international monetary stability without the definite and irrevocable stabilisation of the dollar.

It is hardly necessary to say that the stabilisationist camp in Great Britain, which was highly gratified by this victory for orthodoxy, did its utmost to present the arrangement as a *de facto* stabilisation of sterling. In orthodox quarters it was emphasised that henceforth internal monetary considerations would be subordinated to the requirements of international stability—an interpretation which evidently conflicted with the terms of the official announcement—and that in future the stability of sterling would be defended if necessary by high bank rate and credit restrictions. The mere idea of the possibility of such measures filled the hearts of orthodox economists and City editors with joy.

On the other hand, the adherents of the cheap money school, and those who attached more importance to internal prosperity than to international stability, were satisfied with Mr. Chamberlain's repeated assurances that he meant to continue his cheap money policy. They remained as convinced as ever that, while the authorities would support sterling so long as this was possible without sacrificing internal prosperity, when the choice came between defending sterling with the aid of orthodox deflationary measures or allowing it to find its level, Mr. Chamberlain would choose the second alternative. In any case, they were aware that the gold resources of the Exchange Equalisation Account were ample to secure the stability of sterling for a long time to come without resorting to any measures detrimental to trade.

(3) Gold Earmarking Arrangements

The question was how the new Tripartite arrangement was to operate. Until the devaluation of the franc it had been possible for the British and American Exchange Equalisation Accounts to earmark gold in Paris in order to prevent a depreciation of the franc, while the French authorities were in a

position to obtain gold in New York and in London in the event of an appreciation of the franc. After September 26, 1936, it was no longer possible to earmark gold in any of the three centres. This meant that while each of the three centres was in a position to prevent a depreciation of its own currency by selling gold, they were not in a position to prevent an appreciation unless they chose to take a risk by accumulating a large balance in the other two currencies. This latter course was not considered desirable by the monetary authorities, and negotiations were pursued to find a solution which would enable them to operate both ways without taking any exchange risk.

The result of these negotiations was the conclusion of a new three-power pact on October 12, which was to complete the original Tripartite Agreement. By virtue of the new arrangement, the British, French and United States Exchange Equalisation Accounts would each have reciprocal gold earmarking facilities in the other two centres. It was agreed that balances in the national currency owned by the two other Exchange Equalisation Accounts would be convertible into gold at the current market rate of gold. This arrangement was subject to termination by 24 hours' notice. It enabled the three monetary authorities to prevent an appreciation of their currencies or, what is the same thing, a depreciation of the other two currencies, without having to run any exchange risk.

(4) Informal and Provisional Stabilisation

The significance of the new agreement, like that of the original Tripartite Agreement, was grossly exaggerated in the orthodox camp, where it was presented as yet another step towards a definite return to the gold standard. In reality, the measure was of a purely technical character, and since it was subject to 24 hours' notice it did not tie the hands of the three participant Governments any more than the original Tripartite Agreement did. Nevertheless, it strengthened the Tripartite Agreement, which has definitely assumed the character of a new international currency group similar to the Gold Bloc or the Sterling Bloc, but better organised.

Even allowing for this, the fact remained that the Tripartite Agreement was a decidedly informal arrangement which did not in any way bind any Government to defend the stability of its currency at all costs. It cannot be regarded, therefore, as even a *de facto* stabilisation. This was shown by the

depreciation of sterling by some 3 per cent following upon the devaluation of the franc. The Tripartite Agreement was significant, especially in a negative sense, in that it ruled out a competitive depreciation of currencies. It was widely anticipated that the devaluation of the franc would lead to a further depreciation of sterling and the dollar. Sterling was allowed to depreciate to the vicinity of its former parity with the dollar, but thereafter its downward movement was checked. Although even this moderate degree of depreciation was viewed with disfavour in Washington, it did not lead to any reprisals on the part of the United States authorities. Fears of a currency depreciation race did not thus materialise.

(5) Disadvantages of Tripartite Agreement

Unfortunately even the informal and provisional stabilisation through the Tripartite Agreement was not without its grave disadvantages. For one thing, it was obtained at the cost of reducing to a minimum the extent of the devaluation of the franc, which currency remained in consequence vulnerable even after its devaluation. The fact that orthodox quarters exaggerated the importance of the agreement foreshadowed future difficulties in that it might induce Governments to defend the provisional parities at the cost of sacrifice, even in the absence of any legal liability to do so. We shall see later that M. Blum, having presented the Tripartite Agreement as a great achievement, was not in a position to devalue the franc further when this became desirable, owing to fears that the breaking up of the Tripartite Agreement would create an unfavourable impression. Indeed, the new orthodoxy that has developed rapidly around the Tripartite Agreement carries grave dangers which easily outweigh the advantages of provisional stabilisation.

Apart altogether from the possible political consequences of the self-imposed rigidity which was the fruit of the Tripartite Agreement, its conclusion was a first-rate mistake, even from a purely economic point of view. Although a currency depreciation race would have had many temporary disadvantages, in the long run it would have been decidedly advantageous from the point of view of reducing the burden of excessive indebtedness in France, Great Britain, the United States and a number of other countries. No doubt that solution of the problem of fundamental disequilibrium between fictitious wealth and real wealth would have been far from ideal. It would have been the wrong way of achieving the

right end. The right way would have been to come to an international understanding by which all currencies were devalued to a level at which indebtedness, both internal and international, ceased to be disproportionate to the national earnings derived from productive activity. Since, however, such an agreement would have necessitated a degree of departure from orthodoxy which at present is inconceivable, the next best thing would have been for the world to stumble upon the right solution by mistake. Had France devalued to the extent of, say, 50 per cent, it would have been followed by a further depreciation of sterling, and this again would have induced President Roosevelt to lower the value of the dollar to 50 cents. This in turn might have induced France to devalue further, and so on and so forth.

Doubtless the series of shocks thus administered would have had an unsettling effect, but it would have been worth while to put up with this for the sake of the ultimate benefit arising through a depreciation of currencies to a level at which indebtedness, both public and private, became bearable, and at which the balancing of budgets presented no insurmountable difficulties.

(6) Tripartite Agreement blocks Process of Adjustment

It was therefore a great misfortune, from a political as well as an economic point of view, that short-sighted statesmanship should have resulted in the conclusion of the Tripartite Agreement. While until September 1936 it was the stubborn resistance of the Gold Bloc to devaluation that blocked the way towards the adjustment of fundamental disequilibrium, from that time onward this rôle was taken over by the Tripartite Agreement. The forces of orthodoxy rallied round that agreement in every country. It was presented as an immense achievement, well worth defending irrespective of the sacrifices involved. Indeed, those in favour of stabilisation at all costs went so far as to present it as some kind of political alliance between the three great democratic countries. The absurdity of this interpretation is only too obvious. Anyone who has an elementary knowledge of the American attitude must be aware that there is not the least likelihood of any active intervention of the United States in any European war. Not only would the United States give no military support to France or Great Britain against a German aggression, but, owing to the deadlock over the war debts, even financial support would not be forthcoming this time. From this point

PART VII

AFTER THE DEVALUATION OF THE FRANC

CHAPTER XXXVI

THE FRANC AFTER DEVALUATION

(1) "VINDICTIVE" MEASURES

ON October 1, 1936, a new monetary law, which was to replace the law of June 1928, was passed by Parliament. It had a rough passage in both Chamber and Senate, and at one time it looked as though the Government would suffer a defeat. While the fate of the monetary law was in the balance, dealings in exchanges were suspended in Paris. It was nevertheless obvious that even if Parliament rejected the bill the franc could not have been restored to its pre-September 26 level. It would not have been easy to form an alternative Government to that of M. Blum, and the new Government would have found it impossible to put Humpty Dumpty together again after his great fall. Thus in passing the monetary law, Parliament merely confirmed the *fait accompli*.

The solution chosen by M. Blum was inspired to a large degree by political considerations. In order to meet his own supporters' opposition to the measure, he decided to give it a strong anti-capitalist character by passing a series of vindictive measures against those who made a profit on devaluation. In the case of holders of gold, this profit was to be confiscated altogether. By virtue of the new monetary law it became illegal for Frenchmen to hold gold in France or abroad, and they had to surrender their holdings on the basis of the old Mint parity. This and other vindictive measures made devaluation palatable to the French Communists and Socialists, but they incurred the uncompromising hostility of the French capitalist classes, including the large number of small holders of gold. At a time when it was of vital importance in the interests of the success of devaluation that dishoarding and repatriation should be encouraged, the French Government passed measures calculated to reduce to a minimum the extent of the return of capital.

M. Blum may have realised the difficulty of making a success of devaluation in face of the active hostility of the capitalist classes. He was, however, not strong enough to overcome the pressure in favour of demagogic measures on the part of his own supporters. He had to allow M. Auriol a free hand to attempt by the force of law to compel holders of gold to dishoard. From a moral point of view there was doubtless everything to be said in favour of the vindictive measures against the profiteers on devaluation. It was selfish and unpatriotic to the extreme on the part of Frenchmen to desert the sinking ship, and from a purely moral point of view the confiscation of the profit they had made by doing so was the least penalty they deserved. But from a practical viewpoint it was far more important to secure the success of devaluation than to enforce penalties against immoral gains on the devaluation. After all, what did it matter if a few thousand Frenchmen were allowed to make an unjustifiable but perfectly legal profit through the appreciation of their gold and foreign exchange holdings so long as France as a whole greatly benefited by the consequences of devaluation?

It was an unpardonable mistake to jeopardise the advantages of the country as a whole for the sake of a petty class vengeance. In concentrating its efforts upon seizing individual profits on devaluation, the French Government reduced to a minimum the psychological and material benefit derived from the change. While in other countries devaluation brought about overnight

a fundamental change in the trade and finance of the countries concerned, France was almost the only country where the favourable effects were for the most part short-lived and highly inadequate.

(3) Inadequate Degree of Devaluation

The vindictive measures against profiteers on devaluation were not the only mistake made by M. Blum. Another mistake of equal importance was the inadequate degree of the devaluation. The monetary law fixed the extent of devaluation between 25·19 and 34·36 per cent, allowing the Government a free hand to fix the actual value of the franc anywhere between those limits. The value of the franc was actually fixed half-way between the two limits, so that the monetary reform amounted in practice to a devaluation by 30 per cent, with the right of increasing or reducing this percentage by about 5 per cent through administrative action.

Now, twelve months earlier, the devaluation of the franc by 30 per cent would have been ample. Belgium devalued to approximately the same extent and it proved sufficient to restore the country's prosperity and solvency. Had France followed Belgium immediately, or at any rate within a few months, a cut of 30 per cent in the value of the franc would have been sufficient in every way. It would have restored the equilibrium between French prices and the world level, with a margin to allow for the inevitable rise caused by the increase in prices and wages resulting from devaluation. The profit on the revaluation of the gold reserve would have been sufficient to provide a breathing space during which the French Treasury could have recovered its position and the budgetary deficit could have been reduced to within reasonable limits. Admittedly a 30 per cent devaluation would not have been sufficient to solve the problem of fundamental disequilibrium between fictitious wealth and real wealth, but it would have created a tolerable position.

Since the middle of 1935, however, there had been a sharp rise in French commodity prices, far in excess of the rise in the world price level, and this rise became accentuated after the advent of the Socialist Government, as a result of social legislation and the new wages agreement concluded following upon the stay-in strikes. Inflationary borrowing and rearmament were other contributory factors in the rise in prices and costs in France. Admittedly, even in September 1936 a devaluation by 30 per cent was more or less sufficient to

restore, for the moment, equilibrium between the franc and sterling, though not between the franc and the dollar. But there was no adequate safety margin allowed, either for the inevitable effect of devaluation upon prices or for the effect of the application of the 40-hour week, which at that time had hardly begun to operate. Thus it should have been obvious that even though the devaluation by 30 per cent restored equilibrium between the franc and sterling for the moment, before many months the franc was bound to be once more out of equilibrium. To provide for the probable rise in commodity prices in France it would have been necessary to devalue at least to the extent of 40 per cent.

(4) BUDGET AND TREASURY NOT SUFFICIENTLY RELIEVED

From the point of view of the budgetary and Treasury position, the devaluation by 30 per cent was even more obviously inadequate than from the point of view of restoring international equilibrium. The example of the French devaluation discloses an amazing lack of understanding of how devaluation can solve the budgetary problem. Evidently, devaluation could only be helpful from a budgetary point of view if it led to a substantial rise in prices. Such a rise is accompanied by an increase of the nation's taxable capacity, the extent of which tends to be in excess of the actual percentage of the rise in prices, as a result of the favourable effect of the upward trend upon trade activity. Unless there is such an upward movement in prices, devaluation cannot cure the budgetary deficit. This elementary truth appears to have been overlooked by the French Government, which fixed the rate of devaluation at a low figure in order to avoid a material rise in commodity prices. While it was inevitable that even a 30 per cent devaluation should cause a rise, in spite of the absurd efforts to prevent it by legislation, it should have been obvious that the rise could not possibly be sufficient to balance the budget. Judging by the extent of the deficits, to achieve that end it would have been necessary for prices to rise by at least 50 to 75 per cent.

Nor did the devaluation provide an adequate breathing space for the French Treasury. The profit on the revaluation of the Bank of France's gold reserve amounted to merely 17 milliard francs. Since the beginning of the first major franc crisis in May 1935, the Bank of France had lost gold to the amount of 30 milliard francs, resulting in a corresponding reduction in the profit on the revaluation. Moreover, for

book-keeping purposes the gold stock was revalued on a devaluation of 25 per cent only, the legal minimum degree of devaluation. While the revaluation profit went a long way towards clearing the Treasury's position in relation to the Bank of France, it left no margin to cover the current budgetary deficit, and thus enable the Treasury to abstain from borrowing. And yet in the absence of such a margin there was very little hope of reducing the burden of the public debt through successful conversion operations. While the Treasury remained a large borrower it was impossible to prepare the market for such operations. Thus, by the terms of the devaluation, M. Blum deprived himself of the possibility of reducing the deficit either through an adequate increase of revenue or through a material reduction of the cost of public debt.

(5) Possibility of Further Devaluation

The choice of the system by which the Government was in a position to increase or reduce the extent of the devaluation by 5 per cent in each direction was in itself a mistake in the circumstances prevailing in France. It was a compromise between those who demanded that the franc should remain linked to gold at a low level and those who suggested that France should join the Sterling Bloc or leave the franc free to find its level. It is true that the same system operated successfully in both the United States and Belgium. As is well known, President Roosevelt devalued the dollar to the extent of 41 per cent, reserving the right to change the percentage by administrative action between 40 and 50 per cent. M. van Zeeland devalued the belga to the extent of 28 per cent, reserving the right to change the percentage between 25 and 30 per cent. The fact that the executive power both in the United States and in Belgium was in a position to carry out a second devaluation with a stroke of the pen did not inspire distrust either in the dollar or in the belga, but then the circumstances of their devaluation were totally different from those of the devaluation of the franc. As a result of their devaluation, both dollar and belga became obviously undervalued. There was obviously no need for a second devaluation, and there was no reason for the market to anticipate it.

So far as the franc was concerned, on the other hand, the state of affairs was totally different. It was obvious that even at its devalued level the franc remained at any rate potentially overvalued. This being so, it continued to inspire distrust in the market. In such circumstances, rumours of an impending

second devaluation were bound to arise from time to time. Fears that M. Blum might at any moment avail himself of the right to devalue to the extent of 34·36 per cent without having to pass legislation to that end were calculated to discourage repatriation and dishoarding. Together with the mistaken vindictive policy and the inadequate degree of devaluation, they were bound to reduce to a minimum the beneficial effect of the new monetary law.

CHAPTER XXXVII

THE TWILIGHT OF THE GOLD BLOC

(1) Holland and Switzerland

Within a few hours after the announcement of the devaluation of the franc, the whole edifice of the Gold Bloc collapsed. Among its original members, Belgium and Luxembourg had fallen out through the devaluation of their currencies in March 1935; Italy had withdrawn through the gradual depreciation of the lira and the introduction of exchange restrictions during 1935; and Poland had ceased to count as a member in consequence of the adoption of exchange restrictions early in 1936. After the devaluation of the franc, the remains of the Gold Bloc, consisting of Holland and Switzerland, survived for a few hours. Since the devaluation of the dollar, the guilder and the Swiss franc had been the last remaining currencies at their pre-war parities. Both Holland and Switzerland were reluctant to relinquish this position by devaluing their currencies. Until the very last it was repeated over and over again that even if France were to devalue, it would not affect the determination of the Dutch and Swiss Governments to continue defending their old parities.

Admittedly, general conditions both in Holland and in Switzerland had improved considerably in the course of 1936. In Holland the rise in raw material prices brought about a revival of trade in the Colonies and profits on Colonial trade increased materially. Moreover, Holland was able to resist the rise in commodity prices which took place in France and also in countries with depreciated currencies. In September the index number of wholesale prices in Holland was 62·8 against 62·7 in January. During the same period the index in France advanced from 359 to 420 and in Great Britain from 91·8 to 96·1. Thus the overvaluation of the guilder in relation to sterling became materially reduced while its undervaluation compared with the franc increased.

(2) Material *v.* Psychological Factors

Switzerland was not in such a favourable position, although banking difficulties were less acute than they had been a year before. The index of wholesale prices in Switzerland advanced from 91·9 to 96·8 between January and September, almost in the same proportion as in Great Britain. Nevertheless, there was no acute crisis. Both Holland and Switzerland recovered a fair amount of gold mainly through imports from France and Italy. The technical position of the guilder and the Swiss franc was strong and the fact that until the date of the devaluation of the French franc the discount on their Forward Exchanges remained relatively moderate showed that there was no wave of distrust against either of the two currencies. Allowing for the material factors only, it appeared on the surface fairly reasonable to suppose that both countries would be able to hold out even if France were to devalue.

Where those who adopted this attitude went wrong was in that they completely overlooked the psychological factor. And yet judging by past experience they ought to have known that during times of crisis the psychological factor overshadows the material factors. The suspension of the gold standard in Great Britain was followed by a sweeping flight from the dollar, largely owing to psychological influences. The devaluation of the belga was the starting-point of the run on the remaining Gold Bloc currencies, again largely through its psychological influences. There was every reason to expect that should the French franc be devalued there would be a sweeping attack on the remaining two Gold Bloc currencies.

(3) An Impossible Task

In any case, was it reasonable to expect that two small countries would be able to stand the immense burden of running the international gold standard? Until 1931 sterling provided the main shock-absorber of that system. Between 1931 and 1933 this task was fulfilled by the dollar. From 1933 onwards it was fulfilled by the French franc. All the time there were auxiliary shock-absorbers assisting in the task of running the gold standard. It was simply inconceivable that, after the suspension of the gold standard in the three major countries, two minor currencies left in complete isolation would be able to fulfil that task.

Nevertheless, both the Swiss and the Dutch authorities never missed an opportunity of reasserting their determination

to continue defending their currencies at their old parity. This in spite of the fact that in both countries the number of those who realised the necessity for devaluing was increasing. Some of the bankers and journalists who a year before had been loudest in denouncing those in favour of devaluation had become converted in favour of that step but had not the moral courage to declare their faith. Public opinion in Holland and Switzerland was wholly unprepared for the shock that was to come.

On September 26 the French decision to devalue the franc took both Holland and Switzerland completely by surprise. A few days earlier their exchanges had already begun to feel the strain, especially as many people who found hedging against the French franc too costly resorted to the practice of indirect hedging by selling Swiss francs or guilders instead of French francs, on the assumption that if the latter were devalued the whole Gold Bloc would collapse. On Saturday morning, when the devaluation of the French franc was announced, there was a sweeping selling pressure on both currencies and the Swiss and Dutch Central Banks lost a large amount of gold. There was complete panic in both countries. It was obvious that neither of the two countries would be able to stand the strain for any length of time, since their gold stock would become depleted within a week or two. The experience of the first business hour after the French devaluation became known showed conclusively that the devaluation of the Swiss franc and the Dutch guilder was inevitable.

(4) The Last Denial

In the circumstances the obvious thing to do was to follow the French example. The Swiss and Dutch Governments took that course, but not without a few hours' hesitation which cost their Central Banks many millions in gold, and not without issuing yet another statement emphatically denying any intention of devaluing. This last denial was issued exactly 45 minutes before the act of devaluation was carried out—a fact which does not exactly enhance the value of official denials. In the past it had proved to be necessary on various occasions to devalue or suspend the gold standard shortly after the last denial. Indeed, it was an understood thing that to deny any intention to devalue, even though devaluation had actually been decided upon, was a "white lie". After all, if the Government admitted, explicitly or tacitly, its decision to devalue before it was actually ready

with its arrangements, it would only increase the profits of speculators and reduce the beneficial effect of devaluation. In the past, several weeks, or at any rate days, were, however, allowed to elapse between the last denial and the act of devaluation. This interval, in the case of Holland and Switzerland, could be measured not in hours but only in minutes. In this connection, it is worth recalling that in the annual report of the Netherlands Bank for 1931 the Bank of England was severely criticised because at the end of August it sent a reassuring cable to the Netherlands Bank and devalued nevertheless three weeks later. Little did Dr. Tripp suspect that in five years' time he would be following the British example, with the difference that he would only allow three-quarters of an hour instead of three weeks to elapse. The humiliating and undignified experience could have been avoided had the Dutch and Swiss authorities been capable of swift action by suspending business on that fateful Saturday and making their arrangements over the week-end.

(5) The Rate of Devaluation

Both Switzerland and Holland followed the French example in that they did not devalue their currencies to a definite level but fixed the maximum and minimum degree of its devaluation, leaving it to the Governments to determine the exact level. Switzerland followed the example of France, by fixing the extent of the devaluation of the franc at between 25·94 and 34·56 per cent. Possibly a smaller degree of devaluation might have been sufficient, but the Swiss authorities were wise enough to play for safety. The Dutch Government, on the other hand, was desirous of showing the world that Holland was the strongest of the Gold Bloc countries, and decided to devalue to a smaller degree than either France or Switzerland. No official limits were fixed, but the guilder was held at a discount of about 20 per cent. Undoubtedly, Holland had succeeded to a larger extent in resisting the reflationary tendency that affected Switzerland and especially France during the twelve months preceding devaluation. Nevertheless, the difference in favour of Holland was certainly nothing like 10 per cent. As subsequent events proved, devaluation left Switzerland in a stronger position than Holland exactly because the Swiss Government did not cut the rate of devaluation as fine as the Dutch Government.

(6) End of the Gold Bloc

With the devaluation of the Swiss franc and the Dutch guilder the Gold Bloc came to an end. It had existed for a little more than three years, having been established at the London Economic Conference in July 1933. It had very little practical significance as a monetary union, for the degree of actual co-operation between the member countries was negligible. In the autumn of 1934 the decision was reached to increase the inter-Gold Bloc trade by a modest 10 per cent, but, unambitious as this endeavour was, it never actually became operative to any large degree. The extent to which members assisted each other financially was even more insignificant. Apart from the admission of some Belgian borrowing in Holland, Switzerland and France, there was practically no actual financial assistance to fellow-members of the Gold Bloc. Indeed, each member was endeavouring to husband its resources and reserve them for the defence of its own currency. Admittedly there was a certain amount of technical co-operation between the monetary authorities of the Gold Bloc countries, but then such co-operation existed also with the British and American monetary authorities. It consisted mainly of earmarking arrangements and exchange of information, and had very little practical significance. After the defection of Belgium, the co-operation became even looser, and as the twilight of the Gold Bloc drew nearer it ceased completely. What was established originally to develop into a monetary and economic union became eventually a small group of members who watched each other jealously, half hoping and half fearing that their fellow-members would be the first to devalue.

There can be no doubt, however, that the establishment of the Gold Bloc had the moral effect of strengthening the determination of the countries on a gold basis to continue the defence of their currencies. For years the deflationary policy pursued by the Gold Bloc countries effectively blocked the way to reflation and recovery. While on the one hand President Roosevelt was reflating, France and the other Gold Bloc countries on the other were deflating, thereby offsetting the effect of the reflationary policy in the United States upon the world price level. The existence of the Gold Bloc prolonged the economic depression by at least two years. It was during these two fateful years that economic depression and the overvaluation of currencies led to the development of an

aggressive foreign policy in Italy and Germany. Had the London Economic Conference led to an all-round devaluation instead of giving birth to the Gold Bloc, there would have been an immediate and world-wide trade revival. History might then have taken a different course.

CHAPTER XXXVIII

THE DEVALUATION OF THE LIRA

(1) Effect of French Devaluation

It was inevitable that the devaluation of the franc should be followed by a devaluation of the other two Gold Bloc currencies. There was ample evidence to show that an attempt at further resistance on the part of Holland and Switzerland would have been defeated by a sweeping pressure on their currencies, which would have depleted their gold reserves within a few weeks. There was no choice but to follow the French example. The same cannot be said of the artificial currencies such as the reichsmark or the lira. In both Germany and Italy the exchange situation was purely artificial. There was a watertight system of exchange restrictions, and foreign trade was based largely on a system of barter and subsidies. Technically it was possible for these countries to maintain the value of their currencies, especially as that value was largely fictitious and had very little practical meaning.

It took Signor Mussolini some little time to make up his mind whether or not to follow the French example. Evidently the devaluation of the Gold Bloc increased the difficulties of Italy, since to a large extent the French and Italian export trades are competitive. Italian tourist traffic would also have suffered through the devaluation of the French franc and the Swiss franc. Admittedly the Government was in a position to offset the disadvantages by further increasing subsidies to the Italian exporters, by further depreciating the tourist lira and by other concessions to foreign tourists. Many quarters in Italy were, in fact, in favour of this course.

(2) The Fascist Attitude

From a political point of view, continued resistance to devaluation would have meant the increase of Government intervention in trade. The degree to which commercial and industrial enterprises were dependent for their existence upon the goodwill of the Government would have increased further. For this reason, Left Wing Fascists were inclined to oppose

devaluation, while industrial and other Right Wing Fascists were decidedly in its favour. From an international political point of view, too, the Fascist party was divided into two camps, according to whether they were for or against devaluation. It was an open secret that the German Government did its utmost to dissuade Signor Mussolini from devaluing the lira. By that time, Hitler and Dr. Schacht had definitely *decided not to devalue* the reichsmark. Berlin was anxious that Rome should demonstrate her newly-established friendship with Berlin by following the German rather than the French example. Since the Tripartite Agreement was presented as the united front of the democratic countries, the German Government would have liked to oppose this united front with that of the Fascist dictatorships.

It appeared at the time of the devaluation of the franc as if the readjustment of the Gold Bloc currencies would lead to an immediate all-round relaxation of trade barriers and other restrictions. In fact, the French Government actually reduced the import duties and increased a number of import quotas in order to moderate the rising tendency of commodity prices following upon devaluation. The declared object of the Tripartite Agreement itself was to pave the way towards the return of free international exchange of goods. Evidently this tendency was in conflict with one of the fundamental principles of economic Fascism, which aims at the highest possible degree of national self-sufficiency. For this reason, in addition to the others, strong pressure was brought to bear upon Signor Mussolini to make common front with Germany instead of following the French example.

(3) Signor Mussolini's Belated Decision

Notwithstanding this, after a brief hesitation Signor Mussolini decided to devalue the lira. On October 5 it was announced that the lira would be brought into line with sterling and the dollar by a devaluation of approximately 41 per cent. Thus, after allowing the lira to depreciate materially in practice and after introducing a special tourist lira sold at a depreciated rate, the Italian Government officially abandoned the old parity.

When Talleyrand was informed that Napoleon had died at St. Helena, he remarked: "*C'est une nouvelle, mais ce n'est pas un événement.*" The same may be said about the devaluation of the lira in October 1936. Had Napoleon died while in power, it would have been an event of first-rate importance,

calculated to change the course of history. Had Signor Mussolini devalued the lira only two years earlier, it would have been an event of first-rate importance which would have influenced materially not only financial history but even political history. In 1934 a drastic devaluation of the lira would in all probability have resulted in the collapse of the Gold Bloc. In deciding upon devaluation, Signor Mussolini would have given a constructive lead to the world, and the futile struggles of the next two years, with all their economic, financial and political consequences, would have been avoided. As it was, Italy merely followed the French example, and the official devaluation of the lira made but little difference to the international monetary situation. By 1936 the lira had ceased to play any important part in the international markets, owing to the exchange restriction and the increased adoption of exchange clearing by Italy. From an internal point of view the devaluation of the lira proved the utter futility of its prolonged defence.

(4) Better Late than Never

Notwithstanding this, credit is due to Signor Mussolini for having devalued, even at this late hour. He refused to be influenced by those who saw in the continued overvaluation of the lira a means for increased Government control over trade. Indeed, the strengthening of direct Government control of production and distribution is not in accordance with the fundamental principles of Fascism, which aim at directing individual initiative and the use of private property in accordance with what is regarded as the interests of the community, and not at suppressing them. While at times of depression it is inevitable, even for the Governments of democratic countries, to increase their direct control over trade, this is regarded both in liberal States and in Fascist States as a necessary evil, and not as an end desirable in itself. Signor Mussolini could hardly be expected to be pleased with a system under which the overvaluation of the lira necessitated the granting of heavy subsidies to Italian exporters even after the cessation of sanctions. Subsidies constituted a material burden on the budget. Germany was in a better position to stand such a burden than Italy, for while the former virtually wiped out her indebtedness through the inflation of 1923, the latter carried a heavy burden of public debt and could ill afford to increase it through export subsidies in addition to the deficit due to rearmament expenditure.

(5) Italy's Excessive Public Debt

The existence of a large public debt made it in itself desirable for Italy to follow the French example. Apart altogether from the extraordinary expenditure due to rearmament and export subsidies, the balancing of the budget on the basis of the old value of the lira was in itself a hopeless task. To reduce the real burden of public debt, it was essential to devalue the lira sufficiently to bring about a further rise in commodity prices and in the lira amount of the nation's taxable income.

Thus, while it would have been possible for Signor Mussolini to maintain the lira and to maintain an adequate amount of export trade with the aid of subsidies even in the absence of devaluation, such a policy would have led to a further increase in the burden of public debt. The devaluation of the lira was calculated to bring relief from this point of view, not only by obviating the necessity for export subsidies but also by increasing taxation revenue and reducing the relative burden of public debt charges in the national budget. This must have been considered necessary, if only in order to make the task of financing rearmament easier.

(6) Degree of Devaluation

In deciding to devalue the lira to the extent of 41 per cent, Signor Mussolini displayed more foresight than M. Blum, who kept the degree of devaluation to a minimum. It is true that, since the lira was already depreciated in September 1936, the actual additional devaluation differed but little from that of the franc. Nevertheless, apparently Signor Mussolini must have learnt his lesson, as this time he did not make it a matter of prestige to keep the extent of devaluation below that of France, as he had in 1927. Moreover, he duly realised the advantages of a depreciated currency, and maintained the tourist lira, even after devaluation, at a discount in relation to the new lira. Nevertheless, he did not go far enough. It would have been to his advantage if, instead of restoring the lira's parity of 1927 with sterling and the dollar, he had restored its pre-war parity with the franc. Even that degree of devaluation would not have been sufficient to reduce adequately the burden of public debt. While the international equilibrium of the lira is now more or less restored, the internal disequilibrium between fictitious wealth and real wealth remains in existence.

It is a pity that, having failed to give a lead to the world

for timely devaluation, Signor Mussolini did not give it a lead by devaluing to a sufficient degree to solve definitely the problem of excessive deadweight indebtedness. With his position strengthened as a result of the outcome of the Abyssinian conflict, he could have performed the major operation without running any political risk. Since, however, a really drastic devaluation of the lira would have increased Italy's capacity to rearm, from the point of view of international peace it is as well that Signor Mussolini did not take that course, even if, from an international financial point of view, the example would have been distinctly salutary. If rearmament in Italy continues at its present pace, before very long the real burden of public debt will have become as heavy as it was before the devaluation of the lira. And since Signor Mussolini, having devalued once, is probably anxious to avoid another devaluation, the relative orthodoxy that inspired the choice of the new level of the lira will provide the handicap to unlimited rearmament. So long as relations between Italy and Germany are as close as they are at present, this would be in accordance with the interests of world peace. It is, in a way, fortunate that monetary orthodoxy is not confined to the peace-loving Governments.

Signor Mussolini's decision to devalue was inspired by purely financial and economic considerations. Unfortunately it was not meant to be a gesture indicating the desire to dissociate his foreign policy from that of Germany. Although the devaluation of the lira caused strong resentment in Berlin and was welcomed in Western Europe as a sign of *rapprochement*, before very long it became evident that the decision made absolutely no difference to Italy's foreign policy. This example in itself should be sufficient to dispel the illusions of those who were inclined to exaggerate the political significance of the Tripartite Agreement.

CHAPTER XXXIX

MORE DEVALUATIONS

(1) Anticipated Monetary Changes

The devaluation of the franc, the guilder, the Swiss franc and the lira induced a number of countries outside the sterling–dollar area to revise their attitude towards monetary policy. Several Governments came to the conclusion that since theoretically the franc had become subject to fluctuations between 25 and 35 per cent below its old parity, it had ceased to be suitable for a basis to which their respective currencies could remain anchored. Some countries, such as Greece and Turkey, decided to link their currencies with sterling instead of the franc. Other countries chose the dollar in preference. Since, however, by virtue of the Tripartite Agreement, sterling, the dollar and the franc were to remain reasonably stable in relation to one another, the practical importance of these decisions was for the time being limited.

A much more important question to be decided was whether or not the various Governments should follow the example of the Gold Bloc countries and devalue their currencies. It was widely believed that Germany would take this opportunity of correcting the overvaluation of the reichsmark. Another country of importance whose currency was expected to follow the franc was Poland. After all, until the adoption of exchange restrictions in the spring of 1936, Poland had been considered to be a member of the Gold Bloc, even though she had no free gold market. It was considered unlikely that when the financially stronger members of the Gold Bloc gave up the defence of their currencies the weaker links in the chain would continue to resist. Other countries which were generally expected to devalue included the Danubian states. Although their currencies had already undergone some form of *de jure* or *de facto* depreciation or devaluation, it was widely believed that they would seek to retain the advantages thus obtained by making another cut in their currencies. Czechoslovakia, whose first devaluation to the extent of 16⅔ per cent proved to be inadequate, was fully expected to carry

out a second devaluation. Austria, whose tourist traffic was bound to be affected by the Swiss, French and Italian devaluations, was also expected further to lower the value of the schilling. Hungary, Yugoslavia and Roumania were also mentioned among the countries likely to follow the French example.

(2) German Political Pressure against Devaluation

So far as Germany was concerned, Dr. Schacht took an early opportunity of emphasising the Government's determination not to devalue except under certain conditions which could not be fulfilled, as we shall see in the next chapter. Not being content with taking this decision, the German Government strained every nerve to induce the largest possible number of countries to follow its example and keep aloof from the group of countries included in the Tripartite Agreement. Indeed, Berlin came to regard the decision of Central European countries on devaluation as a declaration of their political allegiance. Strange as it may seem that such political significance should be attached to a purely monetary measure, it was the natural consequence of the efforts to attribute political significance to the Tripartite Agreement as an alliance of democratic nations.

We have seen in the last chapter that, so far as Italy was concerned, the German efforts against devaluation failed. Signor Mussolini refused to make his decision subject to considerations of foreign policy. Without in any way modifying his united front with Herr Hitler, he decided to pursue an independent monetary policy. Other countries displayed, however, less independence. In the first place, Austria and Hungary, having largely shifted from the Italian to the German sphere of influence, did not dare to reject Germany's insistent demand that they should abstain from devaluation. Although in both instances it would have been economically and financially advantageous to devalue, considerations of foreign policy prevailed both in Vienna and in Budapest, even after the devaluation of the lira.

(3) Attitude of Little Entente Countries

On the other hand, Czechoslovakia, being definitely in the French sphere of influence, paid no heed to Germany's wishes and devalued the crown by another 16 per cent. Having decided to repeat the devaluation, she might well have gone further. The experience of the first devaluation should have been sufficient to prove the futility of devaluing at a rate

of one tablespoonful at a time. However, the Czechoslovak action pleased Paris as a gesture to show that Czechoslovakia was still a faithful ally of France.

Yugoslavia, though still a member of the Little Entente, has moved distinctly into the German political and economic sphere of influence. As a large creditor of Germany, she could ill afford to offend her debtor for fear that the latter might stop paying her debt in the form of armament supplies and other useful goods deliveries. Thus the Yugoslav Government decided to maintain the monetary status quo. The decision was less simple in Roumania. Although after M. Titulescu's dismissal there was a distinctly pro-German orientation in the Roumanian foreign policy, the links between Bucharest and Paris were still too strong to be severed openly. Torn between desire to please Paris and desire to please Berlin, the Government eventually found an ingenious formula. The Roumanian leu had already been devalued, though its devaluation was not recognised in law. It was decided therefore to legalise the existing devaluation as a concession to Paris, for old times' sake. At the same time the Government issued a statement emphasising that there was really nothing new in this move and that it had nothing to do with the Tripartite Agreement. This in turn pleased Berlin; thus both France and Germany had reason to be satisfied—or dissatisfied, according to the angle from which they viewed the Roumanian formula.

(4) The Polish Formula

Poland attempted a somewhat similar compromise, prompted by the desire to please Paris without offending Berlin. For some time past a considerable section of Polish expert opinion had been decidedly in favour of devaluation. The former president of the Bank of Poland, Mr. Adam Koc, was the most ardent advocate of devaluation, and when the Government decided to disregard his advice and bolster up the zloty by means of exchange restrictions, he resigned his post. At that time the impression was conveyed that his resignation was due to his disapproval of the exchange restrictions from an orthodox point of view. The truth was, however, that he resigned because he strongly disapproved of the prolonged defence of the zloty at an overvalued level. Admittedly, Poland had succeeded in deflating to a remarkable degree. Between 1929 and 1935, wholesale prices were reduced by no less than 45 per cent, but then Polish prices in 1929 were

considerably inflated as a result of excessive borrowing abroad, so that in spite of the record deflation the zloty remained nevertheless overvalued. The decline in the index number of production bears witness to the destructive effect of the overvalued zloty.

The necessity for devaluation was widely realised in Poland. Even the Central Bank, which in other countries was the hotbed of reactionary orthodoxy, was fully aware of it. Although Mr. Koc gave way to an anti-devaluationist successor, the senior executives of the Bank of Poland remained in favour of devaluation. On the other hand, the Finance Minister remained opposed to it, and succeeded in inducing the Government to resist the demand for devaluation.

Following upon the devaluation of the franc, the decision was reconsidered, but it was decided to maintain the zloty at its overvalued level. Warsaw did not dare to defy Germany. At the same time, since following upon the Paris visit of Marshal Rydz-Smigly, Marshal Pilsudski's successor as Commander-in-Chief and virtual Dictator of Poland, negotiations were being carried on for a French credit, the Government was anxious to make a gesture that would satisfy Paris. A statement was issued declaring Poland's adherence to the Tripartite Agreement—on the basis of the existing level of the zloty. Nobody quite knew what practical meaning such an adherence to the Tripartite Agreement could possibly have. Indeed, apart from being a gesture for political consumption, it had no significance whatsoever. Nevertheless, by that time the political interpretation of the Tripartite Agreement had taken such deep root in French official and public opinion that the Polish statement was received with satisfaction and the credit was concluded soon after.

On the whole, it may be said that the fight between France and Germany had no decisive result. The triumph of Paris over Berlin in the cases of Italy and Czechoslovakia was more or less offset by the acts of submission made to Berlin by the remaining countries, even though some of them sought to preserve the appearance of allegiance to Paris. It may well be asked why such political significance should be attached at all to decisions which are as a rule governed by financial and economic considerations. Evidently the political implications of monetary policy were beginning to be recognised, even though sometimes the recognition led to the wrong conclusions.

CHAPTER XL

GERMAN DEVALUATION DEFERRED

(1) Berlin sulking over Tripartite Agreement

While Switzerland, Holland, Italy and Czechoslovakia followed the French example and a number of countries were hesitating whether to follow it, Germany lost no time in declaring her intention to continue maintaining the reichsmark at its existing level. This came as a surprise, for it was widely assumed that Germany, like Italy, was merely waiting for France to give the lead in order to have a legitimate excuse for devaluing. Indeed, Dr. Schacht's Paris visit in September gave rise to suggestions in the Paris Press that it was he who had proposed the alignment of all currencies. This report was devoid of all foundation, and was merely a case of the wish being father to the thought.

At the time of Dr. Schacht's Paris visit, negotiations for the Tripartite Agreement had not yet reached the concluding stage. When the agreement was actually concluded, the participants announced it to the world without notifying Germany or any other country in advance. This was only natural, for a leakage of information would have led to wholesale bear speculation, which France was naturally anxious to avoid. The maintenance of secrecy caused no resentment anywhere except in Berlin. For the previous 12 months or so the German Government had taken the initiative and sprung surprises on the world innumerable times, and it was intensely annoyed by the fact that for once someone else was capable of confronting it with a *fait accompli*. This annoyance found expression in a statement by Dr. Schacht following upon the publication of the terms of the Tripartite Agreement, in which he criticised that agreement as being inadequate.

(2) Dr. Schacht's Conditions

In the course of this statement, Dr. Schacht enumerated the conditions on which he was prepared to join an international currency agreement. He demanded, among other things, the abolition of trade barriers against German goods;

the consolidation of Germany's external floating debt; the scaling down of Germany's total external debt; and, last but by no means least, the return of the German colonies. If these and a few other conditions were fulfilled, then, and only then, Germany would graciously consent to enter into a stabilisation agreement. Judging by these conditions, the outside observer might easily imagine that Germany was besieged by foreign emissaries imploring her to devalue the reichsmark and that its devaluation would involve heavy sacrifices on the part of Germany and immense advantages to other countries. As a matter of fact, exactly the opposite was true. It was to the interest of Germany to align her currency with those of other countries, while, apart from some considerations of vanity on the part of France, there was no particular desire anywhere abroad to see the reichsmark devalued.

Admittedly there was not the same urgency for devaluation in the case of Germany as in the case of France, or even Italy. Her exchange restrictions had been brought to a fine art and had become as nearly watertight as is humanly possible. The anticipation of eventual devaluation had ceased therefore to lead to any noteworthy outflow of capital. The disadvantages to export trade of an overvalued currency were greatly mitigated by heavy export subsidies, compensation and clearing agreements, and by the use of various types of depreciated blocked marks in payment for exports.

(3) Debtors' Dictatorship

In this respect, Dr. Schacht handled the situation with masterly skill. Having realised that, in the existing state of the world, creditors are at the mercy of their debtors, he endeavoured to accumulate as large commercial arrears as possible. He concluded exchange clearing agreements with a large number of countries and aimed at accumulating a huge debit balance. Having done so, he informed the countries in question that the only way in which these balances could possibly be cleared was through an increase of their purchases of German goods. As a result, Yugoslavia, Greece and a number of other countries had to buy German goods in order to get payment for their exports, even if the price quoted by German exporters was not competitive and if the quality was inferior. Thanks to such skilful tricks, Germany managed somehow to produce an export surplus in spite of the overvaluation of the reichsmark. From the point of view of the

trade balance the devaluation was not therefore desperately urgent.

Nor did considerations of internal equilibrium demand a devaluation of the reichsmark, at any rate at the present stage. Notwithstanding the huge amounts spent on rearmament since the advent of the National Socialist Government, the internal indebtedness per head of the population was still lower in Germany than in most countries. It was incomparably lower than in either France or Great Britain, or even in the United States. The burden of the public debt was not unbearable on the basis of the existing value of the reichsmark, and but for rearmament and public works expenditure it would be easy to balance the budget. It is true that the public debt had been increasing since 1933 at a pace which was without precedent in time of peace. But even if this increase were to continue at the present pace it would be some time before the burden of indebtedness became so excessive as to necessitate devaluation as it had in France.

(4) Germany would stand to Gain through Devaluation

Notwithstanding all this, it would have been to the advantage of Germany to devalue the reichsmark. After all, the export subsidies constituted a heavy additional drain upon the budget of the Reich. With the reichsmark devalued, the task of covering import requirements would have been incomparably easier. If, in spite of this, Dr. Schacht preferred not to devalue, it was due in part to his orthodoxy in matters of monetary policy and in part to the desire of the Left Wing of the National Socialist party to maintain the artificial character of the German economic system. For once Dr. Schacht and Nazi extremists such as Herr Gottfried Feder held identical views. There were, however, other reasons for Germany's reluctance to devalue. The system of blocked marks enabled her to repay a large part of her indebtedness at a fraction of the amount borrowed. At the time of writing, registered marks are at a discount of rather more than 50 per cent, while the discount on security marks and credit marks is between 75 and 80 per cent. The system of blocked marks amounted to a subsidy on German exports paid by Germany's creditors. In spite of this, on balance it would have been to Germany's interest to devalue.

From an international point of view it matters very little whether or not the reichsmark is devalued. Its importance among the world's currencies is now negligible. A large part

of Germany's foreign trade is carried out through exchange clearing and compensation agreements and a further large part is carried out with the aid of blocked marks. The amount of dealings in free reichsmarks in the world's markets is much smaller than the turnover in some of the Latin-American currencies. It may be said that the reichsmark rate which is quoted at its gold parity is almost as fictitious as the Soviet rouble rate. It suits Germany to quote sterling at about 12 reichsmarks, but if she decided to quote at 6 reichsmarks only, there would be no material technical difficulty in putting the decision into practice.

(5) The British Point of View

From the British point of view a devaluation of the reichsmark would be anything but advantageous, since it would facilitate German competition abroad. Germany is, apart from the United States, the strongest competitor of Great Britain in the world markets, and if she chooses to handicap herself by an overvalued currency it is not for British exporters to complain. Considerations of competition played a much less important part regarding France. In her case it was worth while for Great Britain to put up with the immediate commercial disadvantages arising from the depreciated franc for the sake of the general improvement that would in the long run come about as a result of the international alignment of currencies. In the case of Germany, however, these vague advantages might be outweighed by the immediate losses through increased competition. For this reason, if Dr. Schacht imagined that, in order to persuade him to devalue the reichsmark, Great Britain was prepared to forgo part of her claims on Germany, to admit more German goods and to present him with the former German colonies on a silver tray, he was greatly mistaken.

Admittedly, from the point of view of Great Britain and other countries whose exports are competitive with those of Germany, the existing system of export subsidies, blocked marks, clearing and compensation agreements, presents in some ways greater disadvantages than straightforward devaluation of the reichsmark. But there is no reason whatsoever to suppose that after the devaluation Dr. Schacht would relinquish the very real advantages of differential currencies, subsidies and barters. German exports would continue to be subsidised whenever that was necessary. With the basic reichsmark rate devalued, the discount on the various types of

blocked marks would increase the competitive capacity of German trade and shipping. Above all, Germany's bargaining position in regard to clearing and compensation agreements would be much stronger. If Dr. Schacht succeeded in persuading various countries to increase their purchases from Germany in order to liquidate frozen arrears on clearing account, how much more easily would he obtain the terms he wants if German goods were at least as cheap as competitive foreign goods!

(6) The International Point of View

For these reasons it was, to say the least, a matter of indifference from an international point of view whether or not Germany decided to align her currency. It was certainly not worth while for Great Britain or other countries to make any material sacrifices to induce her to do so. Germany's external indebtedness is no longer excessive. While in 1931 a composition with foreign creditors appeared inevitable, in the meantime the outstanding amount has been reduced to such an extent that what is left is well within her capacity to pay. A reduction of the external debt and a devaluation of the reichsmark would merely facilitate Germany's task of accumulating a war chest through the creation of an export surplus, and its repatriation in the form of gold. There is no reason whatsoever why Great Britain, the United States and France should assist her in attaining that end, and there are several reasons why they should not.

If Germany chooses to devalue, other countries are not in a position to prevent it, but for them to make sacrifices in order to persuade her to do so, or even to coax her into deciding to devalue, would be the height of absurdity. If she chooses to handicap herself in the international rearmament race, it is all to the good. Unfortunately, the handicap is not sufficiently severe in her case to make sufficient difference at this stage. Nevertheless, every true friend of international peace should hope and pray that Germany will continue to refuse to devalue. In the absence of devaluation it will be a long time before she will be able to accumulate a gold reserve or raw material reserve sufficient to enable her to risk another prolonged war. The later she decides to devalue, the better.

CHAPTER XLI

HOLLAND AND SWITZERLAND AFTER DEVALUATION

(1) Swiss Franc Undervalued

While in France the results of the devaluation of the franc left much to be desired, Switzerland and Holland presented a totally different picture during the months following the devaluation of their currencies. Their experience is well worth recording, if only to prove that the comparative failure of devaluation in France was due not to causes inherent in devaluation but to the circumstances in which it was applied in one particular country.

Of the two minor members of the former Gold Bloc, Switzerland was by far the more successful in the choice of method of devaluation. Her Government decided to fix the limits of the new Swiss franc between about 25 and 35 per cent below the old parity and fix its actual value at around 30 per cent below the old parity. In this respect it followed the French example, with the essential difference that while in the case of France a devaluation by 30 per cent was barely sufficient, in the case of Switzerland it was ample. Although commodity prices in Switzerland were advancing during 1936, their rise was not nearly so pronounced as that in France. Nor was there any inflationary borrowing from the Central Bank by the Government, or any drastic social legislation making for a sharp increase in the cost of production. A devaluation of the Swiss franc by 30 per cent was more than sufficient to restore equilibrium between Swiss prices and world prices. In fact, after September 26 the Swiss Franc became decidedly undervalued in relation to the French franc, sterling, and possibly even in relation to the dollar.

(2) Trade Revival and Repatriation of Capital

From the point of view of the internal equilibrium, a devaluation by 30 per cent was sufficient, since the public debt of Switzerland bears no comparison with that of France. It is true that from the point of view of private indebtedness it

might have been better to go even further, but if the international undervaluation of the Swiss franc should lead to a real wave of prosperity it would be possible to liquidate much of the frozen assets of the banks and other frozen private indebtedness. So far as it is possible to judge at the time of writing, there is good reason to hope that this will actually be the case. Tourist traffic, which is the country's vital industry, has revived to a remarkable degree, and there are signs of revival in other trades which are not dependent on the spendings of tourists. In October 1936 exports advanced to 84,595,000 francs, compared with 75,859,000 in October 1935. The watch-making, textile and engineering industries all showed signs of recovery.

The Swiss Government was wise enough not to follow the French example in discouraging repatriation and dishoarding. From the very outset the Swiss National Bank was prepared to pay the full market price for gold, and introduced no vindictive measures of any kind against those who benefited by devaluation. As a result, there was heavy dishoarding and repatriation from the end of September, and the process has continued without interruption ever since. It is impossible to ascertain the actual extent of dishoarding and repatriation, since the gold was added to the reserve of the Exchange Equalisation Account and was not therefore published in the Swiss National Bank's return. Judging by the plethora of funds in the Swiss money market, the volume of capital that left its hiding-place at home or abroad must have been very large indeed.

(3) Influx of Foreign Funds Resumed

In addition, since the Swiss franc was considered safe at its devalued level, large amounts of foreign funds sought refuge once more in Switzerland. The boom in Swiss securities following upon devaluation attracted also a certain amount of foreign capital. Exactly two months after the devaluation the Swiss National Bank was able to lower its rediscount rate to the unprecedented figure of 1½ per cent. The rediscount rate of the Swiss National Bank and of the Federal Reserve Bank of New York are at the time of writing the lowest in the world. Considering that the Swiss authorities were never keen on frequent changes in the bank rate, this reduction indicated that they anticipated a prolonged period of easy money conditions.

The banking situation, which was the weakest spot in the

Swiss economic system and which, until the devaluation, continued to give rise to anxiety, improved considerably. It is true that the problem of excessive commitments in Germany remained unsolved. On the other hand, amidst the monetary ease there was no need to worry any longer about the problem of liquidity, which took care of itself. The return of deposits made it superfluous to cut credits any longer, and in any case many formerly frozen internal credits became liquid. Apart from a few isolated insolvencies towards the end of 1936, which were the belated consequence of the depression that preceded devaluation, the Swiss banking system as a whole showed a remarkable change for the better, and is considered once more thoroughly sound.

Throughout the country the atmosphere of depression and tension that had prevailed until the eve of devaluation gave way to the cheerful spirit that accompanies prosperity. The pessimists who predicted death, destruction and disaster in consequence of devaluation had to realise that they had proved false prophets. Indeed, the majority of public opinion no longer regarded devaluation as a necessary evil but as a wise move in the interests of all concerned. Far from leading to revolution, as it was freely predicted in some quarters that it would, devaluation weakened such revolutionary elements as existed. In Geneva the Communists and extreme Socialists who held the majority of seats in Parliament were defeated in November—a fact which goes a long way towards proving that had M. Laval devalued in 1935 instead of deflating, the parties of the Centre would have retained and even strengthened their position in the French Parliament. Even though radical elements resumed their agitation for another referendum on lines similar to those of the "*Initiative de Crise*" of 1935, the response was not encouraging.

(4) The Guilder at Equilibrium

The Dutch Government, in fixing the terms of the devaluation of the guilder, displayed a higher degree of orthodoxy than the Swiss Government. It fixed the actual depreciation of the guilder at about 20 per cent and sought to hold the guilder at that level. Admittedly, deflation in Holland went further than in Switzerland, and there was no rise in Dutch commodity prices during 1936. The moderate reflation which set in during the second quarter of 1935 came to an end in the last quarter, and prices remained fairly steady until the devaluation. Notwithstanding this, the fixing of the rate of

depreciation at 20 per cent compared with 30 per cent in France and Switzerland was somewhat on the orthodox side. It restored the international equilibrium of the guilder, but left no safety margin. In this respect, the Dutch Government pursued the same policy as the French Government, though admittedly Holland was in a better position than France to maintain the guilder at its new equilibrium. The extent of indebtedness in Holland did not necessitate any more drastic devaluation, and technically the Netherlands Bank was still in a position to hold the guilder at 20 per cent below its old parity.

Nevertheless, perhaps it would have been wiser to follow the Swiss example and allow a safety margin. It was because Dr. Colijn and Dr. Tripp, having been averse from devaluation, wanted to show the world that they were still inspired by an orthodox spirit that the rate of the depreciation of the guilder was cut so fine. As things are at the time of writing, the Dutch devaluation has proved to be successful, but for at least a month it appeared doubtful whether the devaluation by 20 per cent would be sufficient. While there was a certain amount of repatriation, at the same time the widespread anticipation that the guilder would have to depreciate further led to much speculative selling throughout October, and the wide discount on forward guilders resulted in the outflow of funds through swap transactions. Admittedly the Dutch authorities were well in a position to cope with this pressure, and before long speculators got tired of bearing the guilder. Throughout November the discount on forward guilders declined, and towards the end of December it disappeared altogether. The repatriation of funds resulted in extremely easy conditions in the Amsterdam market, and for the time *being, at any rate,* all worked out for the best.

Notwithstanding this, it may well be asked whether it was worth while for the Dutch authorities to take even a limited risk by devaluing to an extent at which it remained necessary to support the guilder. If they thought they would earn the world's admiration by keeping down the extent of devaluation, they were distinctly mistaken. The immediate and unqualified success of the Swiss devaluation made a much better impression than the hesitating and belated success of the Dutch devaluation.

(5) Blundering with Impunity

Human memory is short, and both in Holland and in Switzerland the public, having recovered its prosperity, ceased to

think about the unnecessary sacrifices it had been called upon to make throughout 1935 and 1936 for the sake of postponing the inevitable devaluation of the currencies. And yet in the light of the success of devaluation, the lack of foresight of those responsible for the Swiss and Dutch monetary policies before September 1936 became unquestionably evident. I cannot help feeling that they were let off rather too lightly. Having chosen to adopt the policy which they had formerly denounced, they were subject to practically no criticism. Evidently the mismanagement of the monetary policy of a country is not yet regarded as among the major offences of politicians and Central Bankers so long as they change their mistaken policy before it leads to complete disaster. The public in every country knows much more about monetary matters than it did a few years ago, but it will have to learn a great deal more before it is able to force its statesmen and Central Banks to realise the full extent of their responsibility for the consequences of their mistaken monetary policy.

In this connection it is worth recalling that Dr. Vissering, Governor of the Netherlands Bank until 1931, had to resign because of the losses suffered by his bank on the depreciation of sterling. The losses suffered by that bank, and more especially by the Netherlands as a whole, through the unwarranted delay in the devaluation of the guilder were, however, many times larger, but did not lead to the resignation of those responsible for these losses. Monetary policy is still a sphere where bankers and statesmen can blunder with impunity to themselves. They thrive on their mistakes, while their countries pay the price. France was the only country in which those Central Bankers who were responsible for the mistaken monetary policy pursued in 1935–6 were relieved of their functions. Even there, this action was due to their political attitude and not to their monetary policy. The right thing was done for the wrong reason. The experience of MM. de Wendel, de Rothschild, Tannery and Lacour-Gayet does not, therefore, provide an exception to the rule that mistakes in the sphere of monetary policy can be made with impunity.

CHAPTER XLII

THE NEW GOLD STANDARD

(1) Changing Definition of Gold Standard

When the conclusion of the agreement for reciprocal earmarking facilities was announced, Mr. Morgenthau declared that this agreement amounted to the adoption of a new type of gold standard. This suggestion may seem absurd at first sight, since we are used to associating the gold standard with fixed parities. On closer examination, however, it seems that the definition of the new system as a " new type of gold standard " may be correct if we revise our ideas of the gold standard in the light of changed conditions and requirements.

Before the war the gold standard meant the free convertibility of notes into coins as well as bar gold for internal as well as international requirements. The post-war gold standard sought to confine convertibility to international requirements only, and aimed at eliminating coins from the system altogether. Before the war the idea of a gold standard without gold coins would have appeared absurd, but after 1925 it came to be regarded as a matter of course. It is conceivable that the system that came into existence through the conclusion of the Tripartite Agreement will also gradually come to be regarded as the new type of gold standard. The definition of the gold standard is something essentially adaptable. The rules of the system that may correspond to the revised definition of the gold standard, so far as they can be ascertained at this early stage, therefore deserve close examination.

(2) No Rigid or Permanent Stability

The substantial difference between this new gold standard and the system that existed before 1931 is that under the new system, stability is neither rigid nor permanent. Although there may be secret clauses of the Tripartite Agreement fixing definite limits to which the currencies concerned are allowed to depreciate, on the whole the chances are that these limits were left vague, and that exchanges, when subject to very strong pressure, will be allowed to move in a range far in

excess of that of the gold points. There is, in fact, no figure which can be regarded by the market as the highest or lowest point beyond which the exchanges would not be allowed to move so long as the Tripartite Agreement is in existence.

What is even more important, the very existence of the Tripartite Agreement, with its vague limits of exchange fluctuations, is on a 24-hour basis. Any of the participants reserve the right to denounce the arrangement at any time. From this point of view the actual situation differs in practice but little from the old system, since even under the gold standard it was within the sovereign rights of any Government to depart from the gold standard or devalue its currency at any moment, without giving any notice to any Government. While, however, under the gold standard there is a legal parity which cannot be altered without passing legislation, under the new system the parities can be altered by administrative action.

(3) Theory and Practice

In theory the new system means that the Governments are in a position to alter their exchange rates as a matter of expediency without having to defend the existing rates at heavy sacrifice, as they felt bound to do under the gold standard. In practice, however, all depends upon the spirit in which the Governments interpret their right. We have seen in Chapter XXXV that by exaggerating the importance of the Tripartite Agreement the French Government has thoroughly tied its own hands and made it more difficult to make use of its right to alter its parities. The British Government, on the other hand, was at pains to emphasise from the very outset that, notwithstanding the Tripartite Agreement, sterling remained free. This means that, should the defence of the old parity prove to be too costly, Mr. Chamberlain would be at liberty to denounce the Tripartite Agreement and allow sterling to find its level without first putting up that heroic defence which in the past every self-respecting country was expected to display before suspending the gold standard or devaluing.

It is to be feared that, should the Tripartite Agreement remain in force for any length of time, the parities would become in practice as rigid as under the gold standard. Even in the absence of any legal liabilities, the Governments would become increasingly reluctant to allow their exchanges to depreciate, notwithstanding their right to do so. Thus the difference between this new gold standard and the old one is not so striking as would appear at first sight. It all depends

on whether anything happens in the near or comparatively near future to upset the exchange rates, thereby leading either to the breakdown of the Tripartite Agreement or to its revision in the sense of allowing it a higher degree of elasticity.

(4) Significance of the Gold Earmarking Agreement

In substance the participation in the Tripartite Agreement amounts to a promise to abstain from deliberate competitive depreciation of currencies and to defend the currencies in the vicinity of their existing levels as far as this is possible without unduly heavy sacrifices. Had the three participating Governments trusted one another implicitly to carry out the letter and spirit of this promise, there would have been no need to supplement the original agreement with an agreement for the granting of reciprocal earmarking facilities. After all, each of the participating Governments is in a position to defend its exchange against a depreciation by selling gold so long as it possesses a gold stock which it is prepared to sell. The reciprocal gold earmarking agreement was concluded in order to enable the Governments to defend their exchanges also against an unwanted appreciation. But then, on the basis of the original Tripartite Agreement it would have been the duty of the French and American monetary authorities to sell gold and buy their exchanges whenever they tended to depreciate in terms of sterling. Similarly it would have been the duty of the British and American authorities to do the same to counteract the depreciation of their currencies in terms of francs, and it would have been the duty of the British and French authorities to act likewise whenever it was necessary to prevent an appreciation of dollars in terms of sterling and francs.

If in spite of this it was found advisable to make earmarking facilities it was because each of the three Governments was afraid that the other two might not be prepared to go far enough to defend its currency against depreciation. The United States authorities were in this respect particularly distrustful. They suspected the British Exchange Equalisation Account of wanting to bring about a depreciation of sterling in terms of dollars. It was for this reason that the United States authorities were prepared to go out of their way to grant earmarking facilities to the British and French authorities on the basis of reciprocity.

This supplementary arrangement meant that each of the

three Exchange Equalisation Accounts was henceforth placed in a position to support the currencies of the other two. That is, the American Exchange Equalisation Account was thus able to support sterling, even against the wish of the British monetary authorities, so long as the latter were prepared to earmark gold on official American account.

(5) Increased Rigidity of Exchanges

This arrangement increased the rigidity of the Tripartite Agreement to no slight extent. We know that in the past the policy of the British Exchange Equalisation Account was not to resist rigidly any strong tendency, whether it was buying pressure or selling pressure, on sterling, but to moderate and regulate its effects. Thus, when there was a strong and persistent selling pressure on sterling, the rate was not pegged rigidly at the same figure but was allowed gradually to decline to some extent. Under the existing arrangement the decline would be checked by American intervention. The United States authorities would never hesitate to support sterling against a depreciation, especially as it costs them nothing to do so. The cost of the support would continue to be borne by the British authorities, who would lose the gold.

Needless to say, the British authorities are not likely to be prepared to support sterling indefinitely at an inconvenient level. Nor would they be prepared to bring about an unwanted appreciation by means of the working of the earmarking arrangement. Thus while the United States authorities are at liberty to check a depreciation of sterling by drawing upon the British gold stock, they would not be allowed to earmark gold for the purpose of causing sterling to appreciate. In practice they have several means at their disposal for attaining that end without taking any risk. They are in a position to prevent a depreciation of sterling or to cause an appreciation, not only by earmarking gold but also by buying gold in the open market in London. It was observed on several occasions towards the close of 1936 that the moderate rising tendency of sterling was accentuated by American gold purchases in the London market. It is not known whether these purchases were carried out on behalf of the American Exchange Equalisation Account or on account of the banks operating. But since those banks would not undertake the arbitrage if it were disapproved of by the American authorities, the difference is a mere matter of form. The fact remains that in spite of the Tripartite Agreement the United States

authorities have repeatedly bought gold, even though by doing so they deliberately caused the dollar to depreciate.

Evidently this practice is against the unwritten rules of the new gold standard. Although the extent to which these operations have affected the dollar has been relatively small, the principle involved is of importance. Surely it is not in accordance with the spirit of the arrangement if the American authorities buy gold when this is not required for the purpose of counteracting an appreciation of the dollar. It is not exactly playing the game of the new gold standard to cause the currency of another participant to appreciate, however slightly, even though that participant refrains from protesting, for the sake of maintaining good relations between the two monetary authorities.

(6) Elimination of Private Arbitrage

Another characteristic of the new gold standard is the gradual elimination of private arbitrage. So far as France is concerned the export of gold through private arbitrage was prohibited in September 1936, and the exchange was supported through official gold exports. In November the United States followed suit. Even before that, a special licence was required to withdraw gold from the United States for private arbitrage, and it was only granted for the purpose of exporting gold to countries on the gold standard and on the undertaking that the gold would be delivered to the Central Bank. In future, in the United States as in France, the export of gold will be the monopoly of the authorities. At the same time, in both France and the United States, private arbitrage was not eliminated so far as the import of gold was concerned. In Great Britain, on the other hand, it is possible for private arbitrage to import and export gold, but neither the Bank nor the Exchange Equalisation Account is a seller of gold to private shippers. It is not likely that the Government would ever interfere with private arbitrage so far as the gold dealt with in the open market is concerned. The fact that the French and American authorities have eliminated private arbitrage so far as gold exports are concerned but continue to receive gold imported by private shippers seems to indicate merely that they are keener on receiving gold than on giving it up.

Needless to say, all the rules of the new gold standard are still in the melting-pot. It will be some time before any definite set of rules can be generally recognised as being those

of the new system. Moreover, the chances are that before the new set of rules has time to become crystallised some new shock will unsettle the whole system built up by the Tripartite Agreement. It seems reasonable to assume that another devaluation of the French franc is in the long run inevitable. If and when it takes place, it will put the Tripartite Agreement to a very severe test. It also remains to be seen whether in the long run it will be possible to maintain sterling at its present rate in relation to the dollar, in accordance with the Tripartite Agreement.

CHAPTER XLIII

M. AURIOL'S CONCESSION TO CAPITALISTS

(1) Repatriation and Dishoarding

When, after the adoption of the monetary law, dealings in francs were resumed, a strong buying pressure became evident. This was only natural, for, in spite of the unfavourable circumstances described in Chapter XXXVI, the devaluation of the franc was bound to be followed by a certain amount of dishoarding and repatriation. Many people had exported rather more capital than they could afford to keep abroad for any length of time. They were quick to take their profit, even though they had to go about it carefully in order to evade the "vindictive" legislation against devaluation profiteers. The boom on the Paris Bourse which followed the devaluation also led to the repatriation of capital on the part of those who wanted to make the best of both worlds: having made a profit on the devaluation of the franc, they wanted to make an additional profit on the rise in French stocks and shares that followed the devaluation. In addition, the decline in the discount on forward francs made it hardly profitable to keep balances abroad with the forward exchange covered. Most of the considerable amount of swap money was therefore repatriated.

Moreover, there was a certain number of people who, intimidated by the threats of penalties, decided to surrender their gold to the Bank of France at the old parity. This was particularly true in the case of those who felt that they had not succeeded in covering their tracks, and feared that an examination of the books of the French banks might reveal the fact that they held gold abroad. It is true that most of them were ready to explain, if ever called upon to do so, that while they had transferred some gold to London, subsequently they had sold it and lost or spent the proceeds. The trouble was that there were too many people who intended to make the same excuse. Indeed, had the French authorities succeeded in obtaining the list of French holders of gold, and had they insisted upon explanation, there was a danger that London

would soon acquire a reputation in the eyes of Frenchmen similar to that which Paris enjoyed in the Edwardian days, and still enjoys in the eyes of many Englishmen. The number of those Frenchmen who were afraid of cross-examination was by no means negligible, though it was but a fraction of the total of French holders of gold.

(2) Technical Position of the Franc Improved

As a result of the various influences making for dishoarding and repatriation, the French authorities succeeded in obtaining a fair amount of gold during October. Sterling was weak and had to be supported by the Exchange Equalisation Account, and the latter released from earmarking a large part of the gold it had earmarked previously, when sterling had to be defended against a rise through the purchase of francs. The figures of the Bank of France's return ceased to reveal the extent of the influx. According to the new arrangement, all the gold was acquired by the French Fonds de Stabilisation. The Bank of France's gold reserve, which declined to 50,111 million francs at the end of September, was of course revalued on the basis of one franc to 49 milligrammes of gold. This revaluation gave a surplus of about 17 milliard francs, of which 7 milliard francs were added to the Bank of France's gold stock, while 10 milliard francs were transferred to the newly-created Exchange Equalisation Account. Subsequently the latter retransferred 7 milliard francs to the Bank of France in consequence of the influx of gold. Thus the gold reserve of the Bank of France at the end of October amounted to 64,359 million francs. The percentage of the gold cover advanced during October from 54·42 to 64·09, in spite of the increase of the note issue and of private deposits. Once more the technical position of the franc, defended by the first line of defence of the Exchange Equalisation Account, and by the reserve ratio of 64 per cent, appeared to be strong. It seemed as though devaluation had been really successful.

(3) Export of French Capital Resumed

Unfortunately the favourable tendency came to an end at the beginning of November. Repatriation and dishoarding ceased after the most timid holders had surrendered their gold to the Bank of France. The rise on the Paris Bourse having come to an end, speculators and investors sought other fields of operation, and since the London Stock Exchange, and more especially Wall Street, were rather strong in November, much

French capital was once more re-exported to take advantage of their upward trend. Forward francs once more became weaker, and the larger profit on the swap led to fresh transfers of balances abroad for interest arbitrage.

Above all, the anticipation of a second devaluation of the franc led to fresh transfers of funds abroad. Throughout November and during the greater part of December the Fonds de Stabilisation had to support the franc. Its operations were not indicated in the Bank of France's return, for it was in a position to use the gold it had obtained during October for the purpose of supporting the franc. When, however, the credit of £40 millions contracted in London in February 1936 became due, the Fonds de Stabilisation did not possess a sufficient amount of gold to be able to provide the sterling required. The Bank of France had to part with gold to the amount of 4 milliard francs for that purpose. Evidently developments were not nearly so favourable as French official quarters had anticipated. Had they thought during October that the trend would become reversed so soon, they would certainly not have retransferred gold to the amount of 7 milliard francs from the Fonds de Stabilisation to the Bank of France only in order to retransfer once more 4 milliard francs of that amount for the repayment of the London credit.

(4) French Banks' "Passive Resistance"

Throughout November there was evidence of a growing discontent with the Government's attitude on the part of the French financial and commercial community. The "vindictive" measures against "profiteers" of devaluation were strongly resented and the banks virtually refused to collaborate in their execution. Even though they were under legal obligation to supply the Government with information about their clients' foreign transfers, they refused to do so, and displayed what amounted to passive resistance against the Government's efforts to enforce the law. There are all sorts of ways by which banks can frustrate the attempts of the *inspecteurs de finances* to obtain the information required. Accidents may happen through which books may be destroyed. Or the accounts may get confused to such a degree as to preclude investigation. Although in some instances the Government succeeded in tracing some of the culprits and instituting proceedings against them, on the whole their progress in forcing holders of gold to surrender their hoards at the old mint parity was negligible.

In the circumstances the Government was led to reconsider its attitude. Strong pressure was brought to bear upon it to waive some of the "vindictive" anti-capitalist measures. As will be remembered, they were introduced as a concession to Communists and extreme Socialists for their consent to the devaluation. It was therefore politically difficult for M. Blum to repeal the measures, even though their maintenance was obviously against the best interests of France. It was becoming increasingly evident that devaluation could not possibly succeed unless dishoarding and repatriation were encouraged instead of being discouraged.

(5) Missed Opportunities

The setback on Wall Street following upon President Roosevelt's threat of measures against the influx of foreign capital, and the unfavourable tendency of sterling as a result of the British political crisis, would have provided an excellent opportunity for France at the beginning of December to take the necessary steps to encourage dishoarding and repatriation. Had they done so there would have been a maximum of response. It took M. Blum, however, some weeks to overcome the opposition of some of his colleagues, M. Auriol among others. As in the case of devaluation, the latter eventually gave in, but rather too late. And as in the case of devaluation, when after some unnecessary delay the inevitable step was taken, the terms of the concession to holders of gold were inadequate. For the sake of the same political considerations for which M. Blum had jeopardised the success of devaluation he also jeopardised the success of the conciliatory gesture made to holders of gold.

The wise course would have been to declare simply that holders of gold would be paid the full new mint parity. Instead, the Government issued a 3½ per cent loan for three years and accepted subscriptions in gold. For each 100 gold francs subscribed, 140 paper francs were to be repaid in three years' time. The present actuarial value of these 140 francs was, however, some 7 or 8 per cent short of the actual market value of the gold francs. Thus, even though the Government was anxious to make a gesture, M. Auriol succeeded in fixing the terms in a niggardly, pettifogging way.

It was a mistake not to offer cash to holders of gold, or at any rate not to offer them securities with an established market. They were by no means certain that the new loan would have an adequate market and that they would be able to sell their

bonds without a capital loss. Even the fact that the Bank of France was prepared to grant advances on the bonds up to 80 per cent of their value was not sufficient inducement to many holders. The French Government thus missed one more opportunity to secure the success of the devaluation.

(6) Inflationary Borrowing Resumed

In any case, such limited success as could be secured by these inadequate terms, or even such success as could be secured by better terms, was bound to be provisional. The budget debate in December revealed a highly unsatisfactory budgetary state of affairs. It became evident that the deficit was simply incurable, that excessive borrowing, partly from the Bank of France, was inevitable. In fact, after the end of November the Treasury, having repaid part of its debt to the Bank of France, resumed inflationary borrowing. Between November 27, 1936, and January 22, 1937, the provisional loans to the Government increased from 12,298 million francs to 19,398 million francs.

Even though the Government succeeded in obtaining a small amount of gold as a result of the new loan, it was a mere drop in the ocean. The chances of a really large conversion operation to reduce the burden of the public debt remained remote. Indeed, the problem of covering the deficit by means of normal borrowing also remained unsolved. As M. Auriol disclosed in the course of the budget debate in December 1936, 42 per cent of French expenditure goes towards the service of the public debt. Unless and until this percentage is at least halved, the budgetary problem will remain incapable of solution, even if the necessity for heavy rearmament expenditure were to cease. The only way by which the relative burden of public debt could be materially reduced would be through an additional devaluation. This is the solution which the French authorities refused to envisage. They were not prepared even to lower the value of the franc to the legal limit fixed by the Monetary Law, even though in doing so before it is too late they would stand a chance of obviating the necessity for a second devaluation.

(7) A London Credit

By January the gold resources of the French Exchange Equalisation Account had become completely exhausted. In face of the persistent adverse pressure on the franc it was necessary to retransfer 3 milliard francs of gold from the

Bank of France to the Fonds de Stabilisation. At the same time a ten months' credit of £40 millions was concluded with a group of London banks. This latter transaction pursued a twofold end. It provided the Fonds de Stabilisation with additional resources for the defence of the franc and at the same time the conversion of the sterling proceeds of the credit into francs provided the French Treasury with badly needed liquid resources.

The conclusion of the London credit brought, however, no real improvement to the French situation. Like the credit transaction concluded in London a year earlier, it merely enabled the Government to postpone the moment when it would have to face reality. The proceeds covered but a fraction of the amount the French Treasury was called upon to raise by borrowing in the course of the next few months. A further deterioration of the technical position of the franc—which, by the end of January, was almost as bad as before the devaluation—was inevitable.

By the beginning of March the proceeds of the London credit were used up and it appeared as though the resumption of borrowing from the Bank of France and the transfer of gold from the Bank to the Exchange Equalisation Account was inevitable. The necessity for making genuine concessions to capitalists became so evident that M. Blum was able to overcome the opposition to a change of policy. Accordingly, from March 8 onward the Bank of France was prepared to pay the full market price for French-owned gold. Yielding to some extent to the inexorable opposition of financial circles to M. Auriol, the Government appointed a committee of "neutral" experts and placed them in charge of the control of the Exchange Stabilisation Fund and of the market of Government loans. The issue of a loan with currency option was also announced. The rigid pegging of the franc around 105 was abandoned and the rate was allowed to depreciate to about 106½. M. Blum made a statement in which he promised to cut down expenditure and his whole tone implied a conciliatory attitude towards capital and enterprise. The result of these changes was a wave of repatriations. This movement was in progress at the time of writing, but it was premature to form a judgment as to whether it was of a lasting nature. Taking a long view, a further depreciation of the franc appears both inevitable and desirable in the interest of national defence. About this, however, more will be said in Chapter XLVII.

CHAPTER XLIV

STERLING AND THE DOLLAR UNDER THE TRIPARTITE AGREEMENT

(1) Relapse of Sterling after Devaluation of the Franc

We have followed so far the fate of the former Gold Bloc currencies after the devaluation of the franc. Let us now turn our attention to the vicissitudes of sterling and the dollar after September 1936. As was to be expected, sterling weakened considerably after that event. In the course of 1936 it underwent a gradual appreciation in consequence of the influx of funds from the continent. Although the Exchange Equalisation Account reduced the effect of this movement upon sterling through its gold purchases, in accordance with its usual tactics it allowed sterling to yield to pressure slightly and gradually. As a result, the sterling–franc rate rose from 75 well above 76, and the sterling–dollar rate advanced from 4.90 to about 5.05. The market never for a moment doubted that this appreciation of sterling was purely temporary and that it would be followed by a relapse after the devaluation of the Gold Bloc currencies had reversed the trend. This opinion of the market was expressed in the premium on the forward dollar in anticipation of its eventual appreciation in relation to sterling.

After the devaluation of the franc, sterling behaved as it was expected to. Even before dealings in francs had been resumed and before any capital had been repatriated either to France or to other continental countries, sterling weakened appreciably in relation to the dollar, just because everybody expected it to do so. Foreign holders of sterling switched into dollars on an extensive scale.

(2) Selling of Sterling on Account of Soviet Government

Among others the State Bank of the U.S.S.R. sold out its holding of about £1 million against dollars. This transaction, which took place in New York on the afternoon of Saturday,

September 26, after the closing of the London market, gave rise to an outburst of indignation on the part of Mr. Morgenthau. He accused the Soviet Government of trying to wreck sterling. His concern for the fate of the currency of another country would have been very touching indeed but for the fact that the real reason for it was only too obvious. Since sterling was offered for sale in New York, the American Exchange Equalisation Account had to buy it at a rather high rate, even though it was evident that before long the sterling–dollar rate would decline materially. The transaction thus involved the loss of some tens of thousands of pounds by the American authorities. This in itself was slightly annoying, but a much more important reason for Mr. Morgenthau's protest was that he wanted sterling to remain overvalued in relation to the dollar and its depreciation did not suit him at all. Mr. Morgenthau's "war cry" was taken up by that section of the London Press which misses no opportunity to attack the Soviet Government. And since the old atrocity stories and the denunciation of Communism as amounting simply to murder, robbery, and, of course, the nationalisation of women, has worn thin, this new charge was taken up eagerly and not altogether without success. The uninitiated public may really have formed the opinion that the sale of sterling by the Soviet authorities was a hostile act against Great Britain.

To those who were acquainted with the real facts, the campaign sounded, of course, ridiculous. In the first place, the Soviet State Bank, like every other holder of sterling, was fully entitled to sell its holding if it anticipated a depreciation of sterling. The British authorities owe the Soviet Government a small debt of gratitude for having sold it in the afternoon in New York instead of selling it in the morning in London, in which case it would have been the duty of the British Exchange Equalisation Account to buy it up at an unfavourable rate of exchange. This aspect of the transaction is, of course, of small importance. What matters is that in so far as the transaction caused a depreciation of sterling it was welcomed in business circles and even in Whitehall. Even if these so-called "wrecking attempts" had succeeded in bringing down sterling to, say, 4.50, it would have been all to the good.

(3) The Flow of Funds to Wall Street

After the resumption of dealings in French francs and the other devalued currencies there was for some weeks a strong selling pressure on sterling, owing to the repatriation of capital.

The Exchange Equalisation Account had to support sterling persistently, and lost a fair amount of gold in consequence. In addition to repatriations there was also a fair amount of transfer of funds both foreign and British to Wall Street. Frenchmen who did not trust the franc at its devalued level, and who in any case did not wish to repatriate their funds while an anti-capitalist Government was in power, preferred to transfer them to New York. In November, repatriations to France came to a standstill but there was a strong movement of funds to Wall Street to take advantage of the rising tendency that followed President Roosevelt's re-election. The sterling–dollar rate declined to a shade above its old parity. Even at that rate it was distinctly overvalued, and it appeared doubtful whether, in face of the westward trend of funds, it would be possible in the long run to prevent its further material depreciation.

In November, President Roosevelt made a statement foreshadowing measures to be taken against an influx of "hot money"—that is, foreign funds going to the United States for provisional investment and subject to withdrawal at short notice. Although the nature of the proposed measures was not indicated, and most people doubted whether the Administration would in fact be able to do anything effective, the statement, together with the labour troubles which began just at that time in the United States, brought the rise in Wall Street to a standstill. The influx of foreign capital ceased and there were, in fact, some withdrawals by holders who were afraid that President Roosevelt might take discriminatory measures of taxation against foreign capital.

(4) Recovery of Sterling

While in October American financial circles discussed the possibility of heavy repatriations of European capital with some apprehension, fearing that they might affect the credit structure to an unduly large degree, in November the moderate repatriations following upon President Roosevelt's "hot money" statement were considered to be more than welcome. They brought about a setback in the dollar, which suited the policy of the Washington Administration. Indeed, the American authorities actually accentuated the adverse trend of the dollar by continuing to buy gold in the London market. In the circumstances the statement made by Mr. Morgenthau that he was not unduly worried by the appreciation of sterling was not too difficult to believe.

The constitutional crisis in December resulted in a setback in sterling, but after the settlement of the crisis it recovered to its former level. Its firm undertone was interpreted in some quarters as an indication that sterling was, after all, not overvalued in relation to the dollar. We propose to discuss this argument in a later chapter, but meanwhile it is sufficient to point out that capital movements in either direction, such as those taking place before and after President Roosevelt's "hot money" statement, are largely independent of the overvaluation or undervaluation of the currency, and that the weakness of the dollar was deliberately accentuated by official American gold purchases.

(5) Reduction of the Fiduciary Issue

The appreciation of sterling became accentuated following upon the transfer of £65 millions of gold from the Exchange Equalisation Account to the Bank of England. Simultaneously with this transfer the fiduciary issue—i.e. that part of the note issue which is not covered by the metallic reserve—was reduced from £260 millions to £200 millions. For various reasons this was interpreted as a bull point for sterling. In the first instance this measure was widely misunderstood both in England and, more especially, abroad, and was regarded as a deflationary move, notwithstanding the emphatic assurance to the contrary given by the Chancellor of the Exchequer. It was widely believed that the change meant an actual reduction of the note issue, which was certainly not the case, but even those who understood the actual character of the change regarded it as a bull point for sterling because it improved the quality of the note cover, and because it indicated that the amount of gold held by the authorities was much larger than had hitherto been supposed. The transaction was attributed to the *embarras de richesse* on the part of the Exchange Equalisation Account. It was generally assumed that the latter's sterling resources had been used up in gold purchases, and that rather than ask Parliament for an increase the Treasury preferred to raise the sterling by selling part of its gold to the bank. On the basis of this assumption, the total gold held by the Exchange Equalisation Account and the Bank of England, calculated on the basis of the present price of gold, was estimated at about £700 millions. It occurred to few people that the counterpart of this impressive figure was represented by an increased amount of London's foreign short-term liabilities.

Another reason why the gold transaction gave rise to a wave of optimism regarding the prospects of sterling was that it was interpreted as an indication that the authorities expected the influx of gold to continue or at any rate that they did not expect it to become reversed. Apart altogether from the fact that, regarding the future course of the exchanges, even the authorities are not infallible, if it is correct that the Exchange Equalisation Account had used up its resources, then it was necessary to provide for additional sterling resources irrespective of the views taken about the future course of sterling.

The effect of the Gold Bloc devaluation upon sterling and the dollar was not nearly so spectacular as it was expected to be. The United States lost no gold at all; on the contrary, she has added to her formidable stock since the devaluation. The adverse pressure on sterling and the losses of gold caused by it were checked partly through the cessation of French repatriations, partly through the fear of American measures against the influx of foreign capital and partly through the wave of optimism caused by the Bank of England's gold transaction. In fact, since the French credit of £40 millions was repaid in November and December through the sale of gold to the British Exchange Equalisation Account, on balance the British gold stock has probably increased during the three months that followed the devaluation of the franc. Its increase continued during the first two months of 1937, owing to the selling pressure on the franc, which assumed at times considerable dimensions. It was only after M. Blum changed his policy in March 1937 that the tide turned once more.

PART VIII
REARMAMENT FINANCE

CHAPTER XLV

" WEHRWIRTSCHAFT "

(1) Germany and Rearmament

By the end of 1936 and the beginning of 1937 the world's financial situation and outlook had come almost entirely under the influence of the political factor. All the European nations, big and small, and several nations outside Europe, embarked upon feverish rearmament to the full limit of their industrial capacity. Considerations of budget and of monetary policy no longer dictated the pace of public expenditure. All over Europe countries engaged in the armament race were reorganising their economic systems to a greater or less extent, following the requirements of national defence.

It is impossible not to admire the German language for its capacity for producing new words to indicate new notions. After the war I saw a notice-board in Coblenz with the word "*Entfestigungsbehörde*" on it, indicating "the authority in charge of the demolition of fortifications". Few languages would have been able to express the same idea in one single word, however long. In the course of 1936 the German vocabulary became enriched by another ingenious word, "*Wehrwirtschaft*", indicating an economic system based on the requirements of national defence. It was not the word alone which was invented in Germany. The system it indicates was also largely a German invention.

It is the first time in modern history that a nation in time of peace has organised its production and trade with the sole object of increasing its military efficiency. If the sole aim of the system had been to secure Germany against foreign aggression, it would be impossible to find fault with it. But unfortunately the time-honoured slogan that the best way of defence is to attack appears to have been fully adopted by Germany's new rulers, who also have ideas of their own as to the expansion of the frontiers of the Germany they intend to "defend". In a word, the whole German economic system has been placed at the service of imperialistic expansionary designs.

(2) Military *v.* Civilian Requirements

At the beginning of the National Socialist régime, public works were carried out, working hours were reduced and the use of labour-saving machinery was forbidden, in order to reduce the number of unemployed. All this is now past history. The gigantic public works schemes are carried on only in so far as they fit in with the requirements of *Wehrwirtschaft*. Thus, as a rule, motor roads continue to be built only if they are approved by the General Staff as being of use from a strategical point of view. Production has been placed under a strict régime of discipline and has to conform with the requirements of *Wehrwirtschaft*. The only reason why production is not converted altogether to meet military requirements only is that the civil population has, after all, to live in order to provide the required contingents of soldiers, and to produce everything those soldiers require for the successful conduct of warfare. It is also necessary to maintain, and if possible to increase, production for export, in order to procure the raw material and food that cannot be produced in Germany and for which no adequate substitute has so far been found. The object of the Four Years' Plan is exactly to produce substitutes for the largest possible number of goods which are at present imported. Meanwhile, the imports for the requirements of the civil population are being reduced to a minimum so as to enable Germany to import the largest possible amount of raw material required for rearmament.

In Chapter XVIII I described in detail the ingenious and efficient system by which rearmament is financed in Germany. The money spent by the German Government on rearmament has assumed the characteristics of the proverbial magic coin which always came back to the spender over and over again, no matter how many times it was spent. So far as this aspect of the German scheme of rearmament is concerned, it is practically watertight. Its operation is improving instead of becoming more difficult. While at the earlier stages it was necessary for the Government to force banks, savings banks and insurance companies to take up the loans which consolidated the floating debt created through public works and rearmament, during 1936 a fair demand for new Government bonds developed in the German capital market. The loan issued in November was actually oversubscribed. Following the example of a certain Balkan Government which, when informed by its London banker that its issue was heavily over-

subscribed, cabled: " Delighted—allot subscribers in full ", the Treasury of the Reich did not hesitate to give subscribers the whole amount they asked for. Barring unlikely developments which would shake the confidence of the German public in the Government, it is highly probable that the financing of rearmament by means of loans will present no more difficulties in the future than it has presented during the last three years.

(3) Public Debt not Excessive

Admittedly, somebody has to pay the bill sometime. The public debt cannot be increased indefinitely, for its interest service would at a point become an unbearable burden. Germany is, however, very far from that point, which in the case of France, for instance, has already been reached. Although no reliable figures are available, there is reason to believe that the German public debt is still considerably less than one-third of the size of the British public debt, and that the percentage of the debt service to total expenditure is very moderate. From this point of view, Germany is well in a position to continue rearmament at the present pace for years to come. She is, indeed, in a better position in this respect than any of her opponents, with the exception of Soviet Russia.

And when the stage is reached at which the burden of the debt service becomes oppressive, Dr. Schacht will always be in a position to devalue, thereby reducing materially the real burden of the debt. Possibly the reason why he is in no hurry to devalue is that he wants first to accumulate a sufficiently large amount of public debt to make devaluation really worth while. Past experience shows that devaluation in itself does not discourage investors from continuing to subscribe to the loans of the Government which, by cutting the currency, has arbitrarily reduced the real value of their bonds. Even though in 1923 the whole internal debt of Germany was virtually wiped out, the internal credit of the Government of the Reich did not suffer any lasting harm from this. Nor is it likely that a second devaluation to the extent of 50 or even 75 per cent would in any way impair the Government's ability to continue to cover rearmament requirements by means of loans. The chances are that the extent to which the Government would have to avail itself of the Reichsbank's facilities would be negligible, apart from provisional accommodation pending the issue of new loans.

It is therefore essential for the German *Wehrwirtschaft* that she should become self-sufficient, or, failing that, accumulate an adequate stock of gold and raw materials. Otherwise a war of aggression would be too risky an undertaking. While it is conceivable that a ruthless air attack on the enemy's capital might bring a speedy decision, the General Staff is against staking everything on this hope. After all, in 1914 it was confidently expected that the war would not last more than a few months, and yet Germany had to face the necessity of conducting war for more than four years. It is conceivable that the next war, in spite of the superior destructive powers of the belligerents, might also be a prolonged one, and it would be foolhardy for any country to embark upon a military undertaking without being reasonably prepared for this possibility by securing an adequate supply of food and raw materials.

It is therefore reasonably safe to assume that Germany will not strike until she feels herself prepared from an economic point of view. Conceivably the advantages from the point of view of military preparedness are at present on her side, assuming that she would not have to cope with a too formidable coalition of opponents. Economically, however, she is very far from being prepared. It is the main task of *Wehrwirtschaft* to overcome this disadvantage.

(5) Dr. Schacht's Foreign Trade Formula

We have seen in Chapter XL how Dr. Schacht has been able to produce for Germany an export surplus, notwithstanding the handicap of an overvalued currency and in spite of heavy imports in connection with rearmament. Provided that he is prepared to add a sufficiently large amount to the already formidable budgetary deficit for the purpose of subsidising exports, there is no reason why this export surplus should not be maintained, or even increased. His formula regarding trade relations with foreign countries is simple. In his negotiations with countries in relation to which Germany has an import surplus, he insists on the application of the principle of bilateralism. Agreements have, in fact, been concluded with a number of such countries, which had to undertake to buy as much from Germany as Germany buys from them. In his negotiations with countries which have an import surplus in relation to Germany, Dr. Schacht insists, on the other hand, upon maintaining that surplus and collecting the proceeds in cash. His method provides a perfect example of the " Heads I win—Tails you lose " formula. If he has his way, then as a matter of simple arithmetic it is evident that in the course of a number of years Germany will be able to build up a large gold reserve. Some countries have seen through his game, and have realised that owing to this dual policy towards bilateralism the dice are loaded in favour of Germany. Other countries, Great Britain amongst them, have so far let Dr. Schacht have his way.

Throughout 1936 Germany has been gaining ground in raw material producing countries, where she increased her purchases on condition that payment was accepted in the form of goods. At times the formula is reversed, and when submitting tenders for important public works German firms are prepared to accept goods in payment for their work. Every now and then we come across reports from various countries, literally speaking from China to Peru, that German tenders have been successful for the building of bridges, fortifications, or the supply of rolling stock, etc. This is due in part to the heavy subsidies paid to the German firms and in part to the fact that they were prepared to accept payment in raw materials.

Confronted with such methods of competition, British contractors and exporters, working under the old-fashioned system of *laissez-faire*, are hopelessly at a disadvantage. Great Britain

has persistently refused, so far, to adopt the principle of bilateralism, even in instances where this would be obviously to her interest. If Egypt can sell her cotton to Great Britain for cash, there is little inducement for her to place orders with Great Britain, since in placing orders in Germany she can increase her total exports. In such circumstances it is not surprising that the German export trade is gaining ground at the expense of trade in Great Britain and other countries which do not insist on bilateralism.

(6) The "Food Shortage" Bluff

Judging by the degree of food shortage in Germany, it would appear that the exchange position is desperate. This is exactly the impression Dr. Schacht wants to convey abroad. As a matter of fact, judging by the figures of foreign trade, the Government would be well in a position to increase food imports without unnecessarily reducing the imports of raw material for rearmament. In the interest of *Wehrwirtschaft*, it is considered wiser, however, to keep the civilian population on short rations in butter, meat, etc., in order to increase the raw material imports for present and future requirements of rearmament, and in order to accumulate a hidden reserve. At the same time the evidence of food shortage in Germany is expected to go a long way towards inducing Great Britain and France to make her important concessions in the way of foreign credits and colonies for fear that the desperate state of the German nation might lead to an international explosion.

Thus the policy of keeping down food imports is aimed at killing two birds with one stone. It is a policy fraught with grave dangers. While it was intended as bluff, it might become serious far beyond the anticipation of its originators. Conceivably, German public opinion, driven to despair by food shortage and led by National Socialist propaganda into believing that the Western Powers are responsible for its suffering, may develop a sweeping pressure in favour of a reckless military adventure long before Germany is economically prepared for a war. It is easier to start an avalanche than to check it or regulate it. The campaign demanding the return of the German colonies carried but little weight so long as it was not supported by the grim reality of food shortage. Once, however, the reduction of food imports was enlisted in order that the campaign should carry conviction, those responsible for the government of Germany exposed

themselves to the risk that their hands might be forced against their will and in defiance of the whole calculations of *Wehrwirtschaft*, according to which Germany will not be ready to strike for another four years.

The weak spot in the German raw material policy lies in the rising trend of the world prices of raw materials and in the prospects of a shortage in its supplies. The chances are that the raw material countries, instead of being anxious to unload accumulated stocks, will be in a position to dictate their terms to buyers. In that case they may insist on payment in cash. This would mean that the German Government would have to increase its export subsidies considerably in order to obtain the exchange required. Allowing for this, and for the rise in raw material prices, the volume of exports will have to be increased considerably in order to pay for the same volume of imports, and a large part of Germany's industrial capacity will have to be diverted from the requirements of rearmament to those of export trade.

CHAPTER XLVI

BRITISH REARMAMENT FINANCE

(1) Financial and Industrial Aspects

It is a characteristic fact that up to the time of writing no term equivalent to *Wehrwirtschaft* has been added to the English vocabulary. "National defence economy" would be about the nearest translation, but that term has not so far been used, as indeed the notion it covers is itself almost unknown. In Great Britain the economic system has not so far been adapted to the requirements of national defence. There are isolated and increasing signs that the trend is moving in that direction, but as things are at the time of writing the general idea is still that this country will muddle through without any fundamental reorganisation of the existing system.

In examining the position and prospects of British national defence economy, the difference between its financial and industrial aspects is remarkably striking. So far as its financial aspects are concerned, there appears at present no reason for concern. The problems presented by the financing of rearmament are not likely to cause any difficulties whatsoever in the near future. This is due in part to the fact that, notwithstanding repeated statements about its urgency, rearmament is still proceeding at a very leisurely pace, and the amount of additional expenditure involved has so far been moderate. Every day it is declared with increasing emphasis that it is necessary for this country to catch up with rearmament in Germany, and every day the gap between the striking power of the two countries grows wider and wider. From a financial point of view there would be no difficulty whatever in accelerating the pace of rearmament considerably. The Treasury would find it very easy to provide a multiple of what is spent at present on rearmament.

(2) Should Rearmament be Financed by Taxation?

It has been suggested that rearmament should be financed as far as possible by increased taxation. Doubtless there is everything to be said in favour of limiting the profits arising

out of rearmament by means of some form of excess profit duty levied on the profiteers of rearmament. The National Government's attitude in this respect is open to censure, for nothing whatsoever has been done to prevent firms concerned, directly or indirectly, in rearmament from multiplying their dividend, and the Stock Exchange quotation of their shares has been allowed to soar high. From this point of view the Governments of democratic countries might well take a leaf out of the book of the two Fascist Dictators, who took steps at an early stage to stop rearmament from leading to profiteering and Stock Exchange boom by limiting the dividends of joint-stock companies. In Great Britain such a suggestion would be denounced as bordering on Bolshevism. Yet it would go a long way towards solving the financial problem of rearmament, even without the indiscriminate taxation to the bone so dear to the heart of the orthodox economist. Why the bank clerk should be expected to pay more income tax in order that aviation shareholders should receive bonuses of 50 per cent or more is difficult to understand. Taxation should be directed against those who benefit specially by rearmament.

Apart altogether from moral and political considerations which make it desirable to check rearmament profiteering, it is also essential from the point of view of maintaining the price of Government securities at a high level and enabling the Treasury to borrow at a reasonably favourable rate. A non-stop increase in the earnings and dividends of industrial undertakings would inevitably divert the trend of investment from fixed interest bearing securities to equities. This has been taking place already since towards the end of 1936, and has been largely responsible for the slump in the gilt-edged market witnessed in February 1937. It is essential, in the interest of cheap borrowing for the purpose of national defence, to limit in some way the profits or dividends of industrial and commercial concerns.

(3) Financing of Rearmament through Borrowing

Much as the idea is disliked in orthodox quarters, by far the larger part of rearmament will have to be financed by means of borrowing. It was, in fact, generally expected that soon after the National Government was returned at the General Election of 1935 with a declared programme of rearmament, a large rearmament loan would be issued. The Treasury preferred, however, not to resort to this procedure. For one

thing, the slow pace at which rearmament was initiated obviated the necessity for much borrowing at an early stage. Payment on the year's armament orders was due only at a later stage. Even in the absence of a rearmament loan the volume of Treasury bill issue contracted, indicating that there was no need for any heavy short-term financing operations pending the issue of rearmament loans. With the increase of the pace of rearmament, such operations have, however, become inevitable. In fact, the Chancellor of the Exchequer announced in February 1937 the Government's intention to borrow £400 million during the next five years to cover part of the requirements of national defence, estimated at £1,500 million over the whole period. Compared with the absorbing capacity of the London capital market, the amount of £400 million, spread over a period of five years, is very small. It is essential, however, that the flood of new issues should be stemmed in order to reserve an adequate proportion of the investor's resources for the requirements of national defence. Otherwise the Treasury will have to compete with industrialists and company promoters who are prepared to offer tempting yields to the public. Apart from the necessity of checking rearmament profiteering, it is also essential in the interest of national defence to regulate and co-ordinate new issues.

The absence of such intervention, together with the defeatist campaign launched by the opponents of cheap money, caused something like a slump in Government securities in January and February 1937. It is a mistake to believe that such a slump was the inevitable consequence of Government borrowing and trade recovery. The experience of the United States during the last three years conclusively proves that heavy borrowing to meet budgetary deficit is not inconsistent with the maintenance of reasonably cheap short-term as well as long-term money rates. If trade recovery, caused by rearmament or other influences, should threaten to bring about dear money, the remedy lies in the Government's hands. The Treasury is always in a position to bring about an increase of the basis of credit through transfer of gold from the Exchange Equalisation Account to the Bank of England and through instructing the latter to undertake open market operations.

(4) No Self-inflicted Penalty

Needless to say, in orthodox quarters the idea of facilitating rearmament finance by maintaining cheap money is viewed

with strong disfavour. Since owing to political conditions which are beyond our control the nation has decided to sin against the canons of sound finance, it should inflict upon itself well-deserved punishment, if not by "taxing itself to the bone", at least by making the financing of rearmament more costly and more difficult. In the view of Puritan economists it would be downright immoral to encourage the vice of budgetary deficit by making its financing too easy with the aid of a cheap money policy. What is wanted is a high bank rate and stringent monetary conditions. That would teach the Chancellor of the Exchequer, and future Chancellors of the Exchequer, not to embark light-heartedly upon expenditure which cannot be met out of current revenue. Since, however, it is the Chancellor of the Exchequer himself who controls both rearmament finance and monetary policy, and he does not happen to belong to the type that enjoys having his right hand inflict pain upon his left hand, the unsolicited advice concerning high bank rate is not likely to be followed. Indeed, in any case the financing of rearmament will be costly enough to the taxpayer without deliberately increasing its cost just to please a few orthodox economists.

(5) Increase in Burden of Debt necessitates Depreciation of Sterling

As it is, the burden of the public debt is excessive in spite of conversion operations in recent years. If further milliards are added to the public debt, even though the cost of new borrowing remains low, the debt service might increase to the figure at which it becomes simply intolerable. Instead of deliberately increasing it, the Treasury will concentrate all its efforts to find ways of reducing it so far as possible. The reduction could be achieved either by conversions or by a further depreciation of the pound. As a result of the recent slump in Government loans, reduction by conversions has to be ruled out, and the extent to which sterling will have to be depreciated to make the real burden of public debt bearable will have to be increased. Obviously, the burden of public debt, which is excessive when the capital amount is £7½ milliards, would become unbearable when the amount had risen to, say, £10 milliards, on the basis of the existing price level. A material rise in prices accompanied by an increase in the nation's taxation capacity would, of course, reduce the real burden of the debt to a corresponding degree. It is for this reason that the increase of armament expenditure may make

it necessary to allow sterling to depreciate, unless world prices rise sufficiently. Meanwhile, Mr. Chamberlain is not prepared to commit himself to the stabilisation of sterling. He wants to leave the door open for a further depreciation for the sake of being able to finance rearmament without raising the burden of public debt to a prohibitive degree.

(6) Industrial Limitations of Rearmament

We have thus seen that the financial problems of rearmament in Great Britain are by no means incapable of solution. Turning towards the industrial aspects of rearmament, the position is less comforting. The extent to which British engineering and other industries have been capable of coping with the abnormal requirements of rearmament has proved to be remarkably limited. Nor have the existing facilities been used to the best advantage. It is from this point of view that the disadvantages of the *laissez-faire* system compared with the system of disciplined economy become glaringly evident.

Although unemployment in the trades concerned with rearmament has been absorbed, there are still many hundreds of thousands of employables, who, with the aid of good training, would soon be available for increasing the pace at which rearmament can proceed. This would not, however, suit the interests of the skilled mechanics at present engaged in the rearmament trade. They are determined to reap the full benefit of their scarcity value, as they did during the war, in the form of wages which, in existing conditions, are entirely out of proportion to the work performed. Profiteering is not confined to the proprietors of firms engaged in rearmament. Indeed, while the owners' desire to profiteer merely adds to the financial burden of national defence, the workmen's desire to profiteer actually interferes with its efficiency and jeopardises the security of the nation.

The workmen are not, however, alone to blame. Individualism under the existing system of *laissez-faire* constitutes a grave handicap to the efficient organisation of the existing producing facilities in the service of national defence. The Government is equally helpless in face of the tyranny of Trades Unions and the selfish individualism of proprietors. It is still optional for manufacturers to carry out Government orders or to earn bigger profits in other directions. The Government refuses to interfere with their sacred freedom. In the circumstances it is not surprising that the pace of

rearmament is in most respects far behind schedule, even though that schedule itself can hardly be accused of being over-ambitious.

(7) Need for accumulating Food and Raw Material Supplies

Until recently the idea of organising the food and raw material supply of the country had been scorned by the Government. It was only in the late autumn of 1936 that the first step in that direction was decided upon. And yet with the aid of efficient organisation the task would have been infinitely easier than in the case of Germany. For one thing, Great Britain possesses a substantial gold reserve and would be in a position to raise credits if necessary. She has also large claims on raw material producing countries, especially on the Dominions and on Latin America. Transfer difficulties prevent most Latin-American countries from meeting their debt to Great Britain regularly, but there would be no difficulty whatsoever in inducing them to make payment in the form of increased export of raw material and food. In this respect I must refer the reader to my suggestion embodied in an essay entitled " The Way Out ", in my book *Bankers, Statesmen and Economists.*

While as things are at present the building up of food and raw material stocks for the requirements of national defence would present no difficulties, it would be a mistake to be unduly optimistic regarding the future. A turn in the tide of sterling might easily deprive the British authorities of a great part of their gold stock. Should the increase of the adverse trade balance continue, this in itself would reduce the possibility of accumulating stocks over and above current requirements. As things are at the time of writing, some raw material producing countries would still be only too willing to part with some of their stocks, accumulated through the years of depression, in settlement of old indebtedness. There is, however, a distinct tendency towards a complete change of the raw material position. It is conceivable that within a year or two there will be an acute shortage of most essential raw materials, and potential buyers will outbid each other just as they did during the last war. The raw material producing countries would then be once more in a position to dictate their terms, just as they did during the war. Possibly many of them would deal on a strictly cash basis only, instead of supplying raw materials on account of old indebtedness.

There is therefore no time to lose if this country wants to organise its national defence economy. The longer this is postponed the more difficult it will be to build up a large and much-needed food and raw material reserve.

CHAPTER XLVII

FRANCE'S SELF-IMPOSED HANDICAP

(1) Difficulties of Borrowing before Devaluation

In the international rearmament race, Germany has the immense advantage of having started almost entirely without the handicap of a large public debt. Great Britain is in a less advantageous position but, as we have seen in the last chapter, she can for a long time minimise this disadvantage through a policy of cheap money by which the funds required by the Treasury are made available, and, what is more, at a low rate of interest. Even though the British public debt is exorbitant, the Government enjoys the full confidence of investors. This is unfortunately more than can be said about France. During the last two years or so, the amount the French Government has been able to raise from genuine investors has been a fraction of the total required. Deficits have been covered for the most part by borrowing from the Bank of France or from the *Caisse de Dépôts et de Consignations*.

Before the devaluation, conditions were becoming increasingly difficult. The poor response to the Auriol bonds issued during the summer of 1936 showed that the chances of a successful issue of a National Defence Loan were none too bright. The banks which in the past had assisted the Government by taking over Treasury bills were themselves in need of assistance, owing to the withdrawals of their deposits in connection with the flight from the franc. The resources of the *Caisse de Dépôts et de Consignations* were exhausted, as the Savings Banks, whose resources that institution has to handle, were also beginning to feel the drain. There was no choice but to borrow from the Bank of France, once the seasonal influx of revenue had come to an end. It was evident that the technical position of the franc would soon become undermined by this inflationary borrowing. This was probably the main reason that induced the Government to decide upon devaluation.

(2) Inadequate Result of Devaluation

The extent to which the devaluation of the franc made the financing of rearmament easier was disappointingly small. We have already pointed out in Chapter XXXVI that owing to the inadequate degree to which the franc was devalued, and to the ill-advised methods pursued, neither the budget nor the Treasury obtained any substantial relief from the operation. The extent of the rise in taxable incomes through devaluation has, up to the time of writing, been too small to make any fundamental difference to the budget. As for the extent of dishoarding and repatriation, the vindictive measures adopted by the Government have kept it at a low level and the resources available for Treasury borrowing have therefore remained inadequate.

In December 1936 the Government made a belated attempt to make good its mistake, and, in order to encourage dishoarding and repatriation, it issued a new loan for which subscriptions were accepted from holders of gold certificates on advantageous terms. Even then, the gold was not accepted at its full market value, and in any case holders of gold did not like the idea of receiving a Government bond in payment instead of cash. This effort was therefore also inadequate to provide a sufficient amount of liquid resources to meet Treasury requirements for rearmament and for the budgetary deficit in general.

Four months after the devaluation the French Government was confronted by more or less the same problem it had had to face before the franc was devalued. Even though money conditions were not quite so stringent as before September 1936, the volume of resources available for Government financing was limited. The reduction of the bank rate from 5 per cent to 2 per cent did not in any way indicate a corresponding improvement of money market conditions. Market rates declined because the bank rate was reduced, but the fact that the market rate of discount remained most of the time a shade above bank rate is in itself sufficient to show that cheap money in Paris was entirely artificial. The Government's task of raising many milliards for the national defence was as difficult as before.

(3) Rediscounting Treasury Bills

Even though banks had recovered some of their lost deposits, they were not in a position to take over large amounts

of Treasury bills unless they were given adequate guarantees that these bills would be eligible for rediscount without any restriction or difficulty. It will be remembered that, when in 1935 M. Flandin came to office, he induced the Bank of France to rediscount Treasury bills, but the Central Bank was at first reluctant to rediscount Treasury bills freely. Subsequently it adopted a more liberal attitude under M. Laval and his successor, so that when M. Blum assumed office there were some 14 milliard francs of Treasury bills held by the Bank of France. Nevertheless, there was no statutory obligation on the part of the bank to rediscount Treasury bills indiscriminately. It was at liberty to refuse to rediscount them if it did not approve of the person or firm presenting the bills for rediscount, or if the amount presented was in excess of the limit of rediscounting facilities fixed for the firms or persons in question. Since under the new régime the Bank of France was entirely under the control of the Government, the banks were reluctant to place themselves in a position in which they had to depend on the Government's goodwill for their existence. They were therefore not prepared to invest their liquid resources in Treasury bills unless and until they had the guarantee that the Bank of France would rediscount those bills, not as a special favour but as a legal obligation to holders.

(4) Disguised Inflationary Borrowing

Accordingly, arrangements were made to that end in December. Henceforth the Bank of France was to rediscount Treasury bills without any restrictions or discrimination. The obstacle to financing rearmament with the aid of the issue of Treasury bills, as an alternative to direct borrowing from the Central Bank, was removed for the time being. Needless to say, it amounted to opening the way to disguised inflationary borrowing, since in the absence of any increase in the money market resources, the Treasury bills had to find their way to the Central Bank. M. Blum's Government resorted, therefore, to exactly the method which was so severely attacked when produced by the previous Governments.

There was claimed to be, however, a marked difference between the disguised inflationary borrowing arranged for by M. Blum after December 1936 and the same method pursued by M. Laval before him. Before the devaluation of the franc, inflationary borrowing merely served the purpose of bolstering up an untenable position. There was not the least hope of

any improvement of that position. The authorities could not successfully have pursued a policy of cheap money, for in doing so they would merely have facilitated the flight from the franc. After devaluation, however, it was argued, the situation became different. There was no acute flight from the franc comparable with the drain that predominated in the money market before devaluation. There was therefore no reason to suppose that cheaper money would accentuate the outflow of funds and the selling pressure on the franc. It was possible, in theory at any rate, to hope that a policy of cheap money would increase the resources of the Paris money market to a sufficient extent to enable the Government to cover its requirements by borrowing from the public.

(5) The Hoarding Habit

It may be asked why France was not able to follow the example of Great Britain and the United States. In both those countries, especially in the latter, the budgetary deficit did not interfere with the cheapness of money. If the Bank of France could put into circulation a sufficient number of milliards to make money really cheap in Paris, there appears to be theoretically no reason why the cheap money conditions thus created should not enable the Treasury to cover its requirements. In practice, however, there is a fundamental difference between conditions in France and those in the United States or in Great Britain. The hoarding habit of the French public makes it very difficult for the French authorities to pursue a policy of cheap money without resorting to inflation pure and simple. In Great Britain and the United States, money coming into circulation finds its way back to the Government, either directly or through the intermediary of the banks. In France it finds its way into the proverbial stocking.

From this point of view, conditions have hardly improved since the advent of the Socialist Government. Indeed, the strained relations between the Government and the banks were in themselves sufficient to inspire distrust in both. It was a great mistake for the Government to pass legislation empowering it to force the banks to give information about the transactions of their customers. This measure increased the Frenchman's dislike for banking accounts, a dislike which was already strong and widespread before the passing of the new legislation. The Government was fully aware that it was not in a position to enforce the law on an extensive scale without accentuating the extent of hoarding. This was the reason

why the banks felt that they could afford to defy the Government by displaying passive resistance against attempts to ascertain the amount of gold and foreign assets held by their customers.

(6) A Conciliatory Gesture

Having realised that nothing but a genuine conciliatory gesture towards capital and enterprise could restore confidence in the franc, the Government, after months of hesitation, decided in March 1937 to make such a gesture. There was an instantaneous response in the form of wholesale repatriation, but it remains to be seen whether the capital dishoarded and repatriated will stay in France, and whether in any case its amount is sufficient to make a fundamental difference to the Treasury's capacity to cover its requirements. Should this not be the case, the Government would have to resume inflationary borrowing, and the technical position of the franc would deteriorate rapidly. Should the Treasury be able to cover its requirements by means of normal borrowing, it would further increase the burden of public debt. As in Great Britain, a stage would be reached sooner or later at which that burden would become unbearable and would necessitate a depreciation of the currency.

By maintaining the franc at its overvalued level until September 1936 the French Government imposed a handicap upon itself, a handicap which would in the course of time have paralysed the efforts at strengthening the national defence had the franc continued to be defended at its old parity. The devaluation of September 1936 did not remove the self-imposed handicap. It only reduced it to some extent. In fact, the claims of rearmament and those of maintaining the franc at its present level have already come into conflict with each other. M. Blum, in order to restore confidence in the franc, and also in order to be able to defend it at its present level, undertook to reduce expenditure on national defence—and this at a time when the arch-enemy across the Rhine is straining its energies and resources to the utmost to increase its capacity for aggression. It seems that, confronted with the necessity of choosing between the security of France and the stability of the franc, the French nation, personified by its Prime Minister, has once more chosen the franc. Should the danger of German aggression become more acute, however, it is certain that financial and monetary considerations will be cast aside and rearmament speeded up irrespective of cost.

Inflationary financing of rearmament cannot be carried on indefinitely without reducing to absurdity the defence of the franc. It would be to the interest of France not to wait until that stage is reached, but to remove the self-imposed handicap as soon as possible. A further devaluation of the franc would change the situation materially. A rise in prices and a revival of trade would lead to a substantial increase of revenue, and even though expenditure would also rise, the burden of the public debt would decline materially. And even though it would be too much to expect to be able to finance rearmament out of current budgetary resources, the Treasury would be in a better position to increase its borrowing after the reduction of the burden of public debt. A drastic devaluation would remove fears of a further depreciation of the franc, and would lead to wholesale repatriation and dishoarding, provided that the Government avoided repeating its mistaken vindictive measures of September 1936.

CHAPTER XLVIII

REARMAMENT AND REFLATION

(1) Rearmament Finance in Western Europe

Germany, Great Britain and France are by no means the only countries whose financial and economic position has been fundamentally affected by rearmament. Indeed, its influences have extended far beyond the borders of the countries actively engaged in strengthening their national defence. Countries which come under the direct effect of rearmament include the predominant majority, if not the totality, of European countries. Even countries such as Switzerland and Holland, which until now had considered themselves reasonably safe under the cloak of neutrality, have had to embark upon heavy rearmament expenditure. Although Belgium declared, in October 1936, that henceforth she considered herself neutral, her Government nevertheless continued to strengthen her defences. As a result of the easy money conditions created through the devaluation of the belga, it has become possible to finance rearmament with the aid of internal loans at a reasonably low figure.

The same is true concerning Switzerland and Holland, which countries even from this point of view have good reason to be thankful for having followed the example of France. Indeed, the requirements of their increased national defence expenditure would in themselves have precluded the possibility of a prolonged resistance after the devaluation of the French franc. The problem of rearmament finance presents no difficulties in the case of the wealthy countries of Western Europe, unless, of course, they choose to handicap themselves with an overvalued currency.

(2) Rearmament Problems of Poor Countries

What is remarkable is that even countries with limited financial resources were able to swim with the tide. We have seen that lack of capital was no obstacle to the German Government in carrying out rearmament on an unprecedented scale. Its problem was solved by the creation of an efficient

system of vicious circle by which the amount spent came back eventually to the Government ready to be spent again. But even countries as poor as Germany and without the advantages of her efficient and disciplined system have been able to solve somehow their problem of financing rearmament. To some extent they were assisted by external subsidies—in some instances from more than one quarter. But to a large extent even countries such as Austria, Hungary, Yugoslavia or Roumania were able to find internally the gigantic amounts they spent on rearmament. The crisis of 1931 left these and many other countries in a desperate financial state. There was no money available for anything, but when it came to rearmament somehow they all found that after all the money was there.

In some instances rearmament presented, in addition to budgetary and Treasury problems, also problems of transfer, owing to the primitive state of domestic armament industries. These problems were solved for the most part by reducing imports for civil requirements or by concluding barter agreements with countries possessing armament industries with a surplus available for export. In most countries these industries were working at full capacity to execute orders for their own Governments. For political reasons, however, part of the output was allowed to be diverted to potential allies. In Sweden, where the relatively moderate degree of rearmament absorbs only a very small fraction of the output of the local armament industry, the world-wide rearmament constituted one of the factors making for prosperity. The value of armament exports per head of the population is larger in Sweden than in any other country. Similarly in the United States the rearmament industries were beginning to show signs of boom reminiscent of the days of 1914–18. Although the United States Government itself is also increasing its national defence forces, there is much available for export, and it is to be assumed that rearmament in Europe during the coming years will constitute one of the major factors making for a buying pressure on the dollar. The only country outside Europe which has been rearming on a large scale is Japan. Her rearmament dates before that of Germany and, together with the substantial depreciation of the yen, it is constituting a major factor in bringing the economic depression to an end.

(3) Recovery of Raw Material Producing Countries

Needless to say, countries which do not play an active part in the rearmament race also enjoy its beneficial effect, without suffering its disadvantages in the form of a considerable increase of their public debt. From this point of view the British Dominions and Latin America have been in a particularly favourable position since the beginning of the rearmament race. It was mainly the large demand for raw materials in connection with rearmament that broke the back of the economic depression. All the reflationary efforts of President Roosevelt and other statesmen until about 1935 did not produce any results comparable with those brought about by rearmament during 1935 and 1936. The frozen commodity stocks which even in 1935 constituted an important problem and a major obstacle to genuine recovery have become liquidated within a relatively short time. In some instances there is now, in fact, an excess of demand, and the restrictions imposed upon production since 1929 are being gradually abandoned.

The whole continent of South America has recovered economically and financially during 1936 far beyond the most optimistic anticipations. Even Chile, which after the crisis of 1931 was considered to be the darkest spot of a gloomy world, shows signs of becoming prosperous and solvent. No wonder, since her two main articles of export are nitrates and copper, both exceedingly useful for rearmament. Countries such as the Argentine and Brazil are gradually relaxing their exchange restrictions, since, thanks to their increased raw material exports, they can now afford greater freedom of transfers.

(4) World-wide Recovery

From 1930 onward it was largely the depression in the raw material producing countries and the curtailment of their power of purchasing manufactures that led to the world-wide economic depression and financial crisis. It stands to reason that now that conditions in these countries are improving, the increase of their purchasing power should lead to an improvement of conditions in the manufacturing countries. From a financial point of view the restoration of the solvency of these debtor countries will greatly assist the creditor countries, most of which are busily engaged in rearmament. Indeed, we may even witness a wholesale liquidation of former

frozen international indebtedness, which process would, of course, go a long way towards reducing the deadweight burden of fictitious wealth.

Could we view the situation without regard for its political, social and humane aspects, we might arrive at the conclusion that by breaking the back of the depression rearmament was, in fact, a blessing in disguise. Unfortunately there is another side to the picture. Apart altogether from the danger that rearmament may lead to a war—a danger in face of which all its economic and financial advantages simply disappear—it is evident that somebody has to pay the bill. The goods produced are utterly useless from the point of view of both production and consumption. They do not add anything to the national wealth, even though the prosperity their production creates might improve the standard of living. There can be no doubt that most Governments will endeavour to cut down their non-armament expenditure, and social services, cultural institutions, etc., are bound to suffer in consequence. The chances are that public works too will be curtailed. The slums will have to remain until the advent of better times. In some countries the most urgent works in distressed areas continue, in order to pacify Socialist opposition to rearmament. The extent of such expenditure is, however, negligible compared with the cost of rearmament.

How different it would be if the gigantic amounts which are at present spent on rearmament were spent on constructive public works! Admittedly, even then somebody would have to pay the bill, but it would be worth while paying. As it is, the bill will have to be paid without obtaining any corresponding benefit through an improvement in the standard of living.

(5) How the Bill will be Paid

To some extent the bill will be paid in the form of increased taxation. To a very large extent, however, in the case of most countries, it will be paid in the form of the depreciation of the monetary unit. This is the way in which war expenditure was paid for throughout history, with very few exceptions. The larger the increase of public debt through rearmament, the larger the extent to which the monetary units will have to be allowed to depreciate in order to restore the internal equilibrium between fictitious wealth and real wealth.

World-wide rearmament will thus inevitably lead to world-wide reflation. The question is, will the process be regulated

scientifically, or will the empiricism of statesmen, Treasury officials and Central Bank governors lead to developments in which the inevitable depreciation of the monetary unit takes place in an utterly destructive way? The choice lies between well-regulated and controlled reflation and spasms of reckless inflation alternating with periods of artificial and uneasy stability. It is of vital importance that those responsible for the management of the monetary policy of various countries should realise what is going on, and that they should be aware that the process of depreciation of monetary units is an inevitable consequence of rearmament. If they should imagine that they can make an omelette without breaking the eggs, sooner or later facts and realities will force themselves on their attention. It would be a mistake for any country to try to bolster up the value of its currency in face of a process which makes its depreciation in the long run inevitable. Stubborn resistance to the natural monetary consequence of rearmament would only lead to prolonged periods of tension and frequent shocks by acute crises. The difference between this process and that of well-regulated reflation is similar to that between panicky flight and orderly retreat. It is for the statesmen of the nations to decide which they prefer.

PART IX
FUTURE PROSPECTS

CHAPTER XLIX

STABILISATION DREAMS

(1) Tripartite Agreement stimulates Stabilisationist Movement

Dealing with the Tripartite Agreement in Chapter XXXV, I pointed out that one of the effects of its conclusion was the encouragement of hopes in the orthodox camp for an early stabilisation. The stabilisationist camp received new converts under the influences of the provisional stabilisation through the Tripartite Agreement. Indeed, during the last quarter of 1936 and early in 1937 it appeared as though the stabilisationists had definitely gained the upper hand over their opponents. After the fluctuations that followed the devaluation of the Gold Bloc currencies, movements within the sterling–dollar–franc triangle narrowed down considerably. It is true that this was largely due to Exchange Equalisation Account operations, but the evidence of stability nevertheless gained many converts in favour of stabilisation.

The adherence of Belgium, Holland and Switzerland to the Tripartite Agreement further added to the impression that we had entered an era of pre-stabilisation. With the Sterling Bloc currencies stabilised in relation to sterling, the actual area of provisional stability through the Tripartite Agreement extended over the whole of Northern and Western Europe, parts of Southern Europe, the British Empire, the United States and Japan. And since the declared policy of the remaining countries was to maintain their currencies at their existing levels, it may be said that by the end of 1936 there was *de facto* stability practically all over the civilised world.

(2) Disequilibrium beneath Surface Stability

Impressive as this almost universal stability may appear, it covers a state of disequilibrium, and its existence is threatened by strong undercurrents that become visible on close examination. Those responsible for the inauguration of the Tripartite Agreement are themselves far from certain that it will last. From time to time exchanges of views take place between

London, Paris and Washington about the possibility of a further adjustment. Apparently, the British and United States Governments raised no objection to a departure of the franc from the figure of 105 at which it was kept for some five months.

There is indeed no equilibrium within the sterling–dollar–franc triangle. Regarded from the point of view of sterling, the dollar is distinctly undervalued. Stabilisation on the present sterling–dollar level would inevitably mean a persistent adverse pressure on sterling. As for the franc, it is at the time of writing probably more or less at equilibrium in relation to sterling, and consequently it is distinctly overvalued in relation to the dollar. Although the disequilibrium within the triangle is not nearly so pronounced as it was before the devaluation of the franc, its existence is beyond doubt. Moreover, the chances are that in the course of time the disequilibrium will become accentuated by the rise in British prices in excess of American prices and through the rise in French prices in excess of both British and American prices.

(3) Perpetuating Disequilibrium

If the Governments should decide to stabilise at the present level, it would merely perpetuate a state of disequilibrium, with all its adverse consequences. Stabilisation would be dangerous unless it created a reasonable degree of equilibrium. It may be argued that, admitting all this, it would be possible and advisable to bring about international stabilisation in connection with which the various exchanges should be adjusted to their equilibrium level. There is, however, not the least likelihood of an agreement between the principal countries regarding the rates at which their exchanges would be at equilibrium in relation to one another. Mr. Morgenthau's idea of a sterling–dollar equilibrium is between 4.86 and 5.00. The British Treasury's idea is 4.50 or under. Views differ also regarding the equilibrium level of the sterling–franc and the dollar–franc rates.

It would be extremely difficult to ascertain, even scientifically, the present equilibrium levels, and even more difficult to induce the parties concerned to agree upon stabilising at these equilibrium rates. Most difficult of all would be to form an opinion how these equilibrium rates would be affected by future developments. Financial, economic and political conditions in the world are in a state of flux. There are international developments which may in future affect the

position in the United States, Great Britain and France to a totally different degree. Over and above this, in each of the three countries there are important internal developments whose effects upon the equilibrium level of their exchanges is simply incalculable at the present stage.

(4) The Franc and Sterling

Everybody capable of clear thinking must realise that sooner or later a further devaluation of the franc is inevitable. Any suggestion of the extent of the eventual devaluation is, however, sheer guesswork. There is no basis for calculating the extent to which French internal prices are likely to be affected by the upward trend of world prices and by the effect of internal inflation, industrial disputes and social legislation. Nor is it possible as yet to form any definite opinion about the level of prices at which the balancing of the French budget might become possible. The rate at which it is safe to stabilise the franc, or indeed any currency, definitely, should be such as to secure both international and internal equilibrium. It may take years before we can form a reliable idea about that rate.

The difficulties of sterling are not so acute as those of the franc. On the other hand, its technical strength is also considerably less. Notwithstanding the substantial gold holding of the Bank of England and the Exchange Equalisation Account, it is doubtful whether Great Britain possesses any net gold surplus above the amount of London's foreign short-term liabilities towards foreign countries. For this reason, a relatively small degree of international disequilibrium would endanger the stability of sterling. Internally, too, it will become necessary to restore equilibrium between the burden of the public debt, which is to be increased through rearmament, and the nation's productive income. It is impossible to form an opinion at the present moment about the degree of devaluation which will eventually become necessary in order to attain that end.

(5) Dollar's Strength

Compared with the position of the franc, and also with that of sterling, the position of the dollar is distinctly comfortable. Even allowing for the large amounts of foreign capital invested in the United States the net surplus of gold reserve is formidable. Indeed, the United States could well afford to stabilise on a basis which would leave the dollar, if

anything, somewhat overvalued. She could well afford to lose some gold pending readjustment. But the question is, would the Washington Administration be willing to accept such a solution? Judging by official statements and actions in the course of the last two years, the answer is definitely in the negative. The United States Government is at least as anxious as the British and French Governments that its currency should not be left overvalued. It is largely for this reason that stabilisation will remain impracticable for a long time to come. Were the Washington Administration prepared to put up with the inconveniences of an overvalued currency pending the adjustment, it would be comparatively easy to come to terms by erring on the safe side when fixing the definite parities of the franc and sterling. Since, however, the United States is not willing to agree to such a solution, it will be necessary to wait until it becomes possible to form a better idea about the approximate equilibrium level.

There are, moreover, many unknown factors also, outside the sterling–dollar–franc triangle. The rates prevailing within the Sterling Bloc have been stable for some time, but this does not mean that the members of that group are all satisfied with their parities, or that they will in the long run be able to maintain their exchanges at their present level. The prospects of the yen are closely associated with the political developments in the Far East. Tension between Japan and the Soviet Union, or between Japan and China, would necessitate military expenditure on a scale that would render a further depreciation of the yen inevitable. In India, too, there is a strong agitation in favour of a downward adjustment of the sterling–rupee ratio. Although at present the official view is distinctly against such a change, the matter may have to be reconsidered in the future. The currencies outside the Tripartite Agreement and the Sterling Bloc are also liable to depreciate or devalue to a large degree. The uncertainty of the eventual fate of the reichsmark is particularly important among the unknown factors.

(6) Political Uncertainty

The uncertainty of the international political outlook is one of the most important arguments, if not the most important argument, against an early stabilisation. It is true that some advocates of immediate stabilisation go so far as to assert that it would go a long way towards improving the international political situation and outlook. There is, however,

no reason to suggest that this view is correct. International monetary stabilisation would make no difference whatsoever to the ambitions of National Socialist Germany, which, after all, is the chief disturbing factor in the international political situation. We have no right to assume that, should the currencies stabilise in circumstances which would enable Germany to export more freely than she does now, her Government would abandon its claims to colonies and for the unification of territories inhabited by German or Germanic peoples, or her far-reaching plans of *Drang nach Osten*. On the contrary, it is under the existing conditions that Germany's difficulties of covering her raw material requirements might sooner or later check the pace of her rearmament and might induce her to adopt a more reasonable foreign policy.

Barring an international political settlement there is no likelihood of disarmament, or even of the limitation of rearmament. Nobody knows at what pace rearmament will have to proceed in the course of the next few years. Quite conceivably the real or imaginary proximity of enemy aggression would induce some countries to increase rearmament to dimensions comparable with those of 1914–18. With this possibility on the horizon, it would hardly be wise to stabilise, especially in circumstances which would impose a handicap on the pace of rearmament.

(7) Popular Demand for Expansion

But even if by some miracle the nations should succeed in coming to terms regarding the limitation of armaments, and even if they were to trust each other sufficiently to keep the agreement thus reached, it would not mean that the road would be open for immediate stabilisation. In some of the countries, at any rate, there would be a strong movement in favour of retaining a free currency in order to be able to pursue an expansionist policy. Rearmament certainly had the beneficial effect of serving as an eye-opener to the public. The Governments which discarded their budgetary orthodoxy and decided to spend hundreds of millions on rearmament can no longer plead financial inability to meet the most urgent social reforms. Evidently the money is there if required for rearmament. A large and increasing number of people will demand that when not required for rearmament it shall be there for constructive purposes. Indeed, even in the absence of a limitation of armaments, there would be a strong pressure in favour of expansionary expenditure on slum clearance and

on distressed areas. Governments will be reminded that since milliards appeared to be available for rearmament, hundreds of millions should be made available also for the improvement of the living conditions of those who need it most. The extent to which the authorities can resist this pressure in favour of expansion will vary from country to country, and this is bound to affect their relative price levels.

Admittedly, if exchanges were to be stabilised at their present level the revaluation of the gold reserve would give, for some countries at any rate, fair scope for an expansionary policy. Moreover, on the basis of the present price of gold, profits on gold production are high, and this is likely to lead to a lasting increase of the output. The increase of the world's gold supply available for monetary purposes would further widen the scope for expansion.

(8) Is there too much Gold?

Indeed, some economists—Mr. Hawtrey among others—are of the opinion that on the basis of the existing price of gold the scope for expansion is too wide and is likely to lead to wholesale inflation. I cannot understand this view, let alone share it. After all, the experience of 1931 has taught all the nations that it is dangerous to work on narrow margins of gold reserve. There is genuine need, from an international point of view, for bigger safety margins than we had in 1931. For this reason alone, only a small part, if any, of the increase of the world's monetary gold stock—whether through book-keeping revaluation or through increase of output—will be available for internal monetary expansion. In addition, the maldistribution of gold which was the cause of much evil before 1931 is now even more pronounced than it was six years ago. The chances are that the United States will sterilise its huge and growing surplus, while most other countries will have to struggle with an inadequate gold reserve, which will leave no scope for internal expansion, having to serve the purpose of international stability.

From the point of view of internal expansion it will therefore be necessary to resort to further devaluations in order to create the margin necessary for expansionary purposes. For the same reason, many Governments will hesitate to link their currencies to gold in order not to burn their boats in face of the popular demand for an expansionary policy. Given these facts, the prospects of an early stabilisation are anything but favourable.

CHAPTER L

THE OVERVALUED POUND

(1) Sterling–Dollar Rate around 4.90

The position and prospects of the franc after its devaluation have been adequately dealt with in earlier chapters. Let us now turn our attention to the position and prospects of the pound as they appear to us in 1937. We have seen that, following upon the devaluation of the franc, sterling was weak for about two months, at first owing to the repatriation of continental balances and subsequently through the attraction of Wall Street for British and foreign funds in London. Towards the end of the year, however, sterling became distinctly firm in relation to both franc and dollar. While the French authorities counteracted this firm tendency by buying francs, the American authorities allowed the dollar to depreciate in terms of sterling; in fact, they actually encouraged the appreciation of sterling. Towards the turn of the year, the sterling–dollar rate was in the vicinity of 4.91, which is a premium of about 1 per cent against its old parity. During the first quarter of 1937 sterling remained around 4.88 to 4.90.

This sterling–dollar rate suited the United States authorities, even though they would have preferred to maintain the rate of over 5.00 prevailing before the devaluation of the franc. Indeed, they had no reason to be dissatisfied, since gold was pouring into the country. Even though the trade balance of the United States was less favourable in 1935, allowing for the invisible exports there was still a substantial surplus.

The question is, does the level of 4.90 or thereabouts suit British requirements? It is an open secret that official British quarters would definitely prefer a lower rate. There is reason to suppose that they feel so strongly about it that American insistence upon the 4.90 level would in itself be sufficient to preclude a definite stabilisation of sterling so long as the conditions which make a lower rate appear desirable still exist. On the other hand, the United States Administration, especially Mr. Morgenthau, would not consider the idea of a sterling–dollar rate below 4.86. The deadlock is

therefore complete. Even if the British authorities were from every other point of view prepared to stabilise forthwith —which they are certainly not—the difference of opinion about the rate at which sterling should be stabilised definitely in relation to the dollar is in itself sufficient to prevent stabilisation.

(2) Policy on a 24-Hour Basis

Since there are many other reasons for which the British Government is in any case not prepared to stabilise for a long time to come, the question of the rate of stabilisation is well in the background. On the other hand, the question of the actual sterling–dollar rate is very much in the foreground. It arises whenever there is some definite tendency in the sterling–dollar rate, especially when sterling has a distinctly weak trend. Under the Tripartite Agreement and the subsequent arrangement for reciprocal earmarking facilities, the United States authorities are in a position to support sterling against a depreciation. It remains to be seen to what extent the Exchange Equalisation Account would allow its gold stock to be depleted through American earmarking. Would the British authorities allow that gold stock to be depleted completely, and would they even draw upon the gold stock of the Bank of England, or would they regard the latter's gold stock as indispensable for internal expansion, and would they even wish to retain some gold in the Exchange Equalisation Account as an emergency reserve ?

In all probability the British policy in this respect, as in so many other respects, is on a 24-hour basis. A decision will be reached as and when the necessity arises. It is reasonable to assume that the Treasury's attitude will depend to a very large degree upon the nature of the adverse pressure on sterling. If it appears reasonable to assume that the pressure is due to speculation, or to some other temporary factor, then the British authorities will doubtless be willing to part with as much gold as they can safely afford to lose without having to restrict credit at home. If, however, it appears reasonable to assume that the pressure is due to fundamental disequilibrium through the overvaluation of sterling, then in all probability the Treasury will not be prepared to waste too much of its gold stock in bolstering up the exchange at an untenable level. Thus as soon as a persistent adverse pressure on sterling develops, the Government will have to make up its mind whether or not it considers the pressure to be due to an overvaluation of sterling.

(3) Is Sterling Overvalued?

It also remains to be seen whether the Tripartite Agreement is sufficiently elastic and whether it is interpreted by the principal parties in a liberal enough spirit to survive a depreciation of sterling due to pressure caused evidently by its overvaluation. The chances are that Mr. Morgenthau would refuse to consider the idea of agreeing to a depreciation of sterling no matter how strong the adverse pressure might be. Should the British Government arrive at the conclusion that sterling was untenable in the long run at its present overvalued level, it would in all probability mean the end of the Tripartite Agreement.

Thus the Tripartite Agreement stands or falls with the defence of sterling around the level of 4.90. The supporters of a stabilisation-at-all-costs policy are fully aware of this. They realise that it would be idle to try to persuade Mr. Morgenthau that since sterling is overvalued it should be allowed to depreciate within the framework of the Tripartite Agreement. And since they are determined that the Tripartite Agreement shall be maintained at all costs, they concentrate all their efforts upon proving that sterling is, after all, not overvalued and that it could and should well be maintained around the level of 4.90. Even quarters which formerly supported the Treasury in its attempt to induce official American quarters to agree to a lower rate of exchange have changed front and have conveniently realised that they were wrong in the past. The stabilisationist offensive has assumed the form of arguing that sterling is not overvalued. An impressive array of arguments is marshalled in support of that contention. On every occasion when sterling is firm, for no matter what reason, it is triumphantly pointed out that after all those who maintain that it is overvalued are wrong. Whenever it is weak, the adverse tendency is attributed to provisional influences which have nothing to do with its overvaluation.

(4) Measurement of Overvaluation

Doubtless it is not easy to form even an approximate opinion about the equilibrium level of the sterling–dollar rate. The problem is not one of simple arithmetic, and cannot be solved by means of a comparison of two sets of index numbers. On the basis of such a comparison, the dollar appears to be, if anything, overvalued in relation to sterling. There was,

in fact, a sharp rise in the average wholesale prices in the United States since 1933 which wiped out the effects of deflation during the previous years. This rise was due, however, for the most part to the higher prices of food and raw materials. So far as the price of manufactures is concerned, the rise was more pronounced in Great Britain than in the United States. And since the export trade of Great Britain consists mainly of manufactures, the equilibrium level of sterling has to be reckoned largely on the basis of the comparative cost of British and American manufactures. The problem is one which deserves far more attention than it has been given so far by expert statisticians. No adequate sets of index numbers have been worked out to simplify the calculation of Purchasing Power Parities and to facilitate arriving at a conclusion whether or not a currency is undervalued or overvalued.

In the absence of such statistical guides, we have to rely upon the practical facts which indicate the overvaluation or undervaluation of the exchange. These indices are the balance of trade and the tendency of forward rates. The former is, needless to say, by far the more important, the more convincing and the more reliable of the two.

(5) Britain's Trade Deficit

The tendency of the British trade balance during 1936 was quite sufficient to prove the overvaluation of sterling. In the course of that year, British imports increased by £92,895,000, while exports, including re-exports, increased by £19,998,000 only. The adverse balance of visible trade increased by the formidable figure of £72,897,000 to £347,801,000. It is impossible to get away from the fact implied in these figures. Those who are anxious to prove that sterling is not overvalued are, of course, ready with the answer that the large increase in imports was due to rearmament requirements and therefore does not indicate an overvaluation of sterling. Admittedly part, but by no means all, of the increase in the trade deficit can be attributed to rearmament requirements. But, it may well be asked, if sterling is not overvalued, and British manufacture prices are therefore competitive, how is it that the additional purchasing power placed in the hands of foreign countries through the increase of British imports has not been spent on the purchase of British goods? In spite of the growing tendency towards diverting trade into artificial channels through subsidies, bilateralism and other means, British exporters would have received a larger share of the

additional £92,895,000 placed in the hands of foreign exporters to Great Britain but for the fact that, on the basis of the existing value of sterling, British goods are too expensive.

(6) Invisible Exports

The answer of the stabilisationist camp to this argument is that the additional surplus of visible imports has been more or less offset by the increase in British invisible exports. So long as figures of invisible trade for 1936 were not available, the stabilisationists were safe in putting forward this argument, which they support by sets of figures elaborated to suit their purpose. To the question: When does invisible trade become visible? the answer is: When it is required for the manufacturing of proofs that after all sterling is not overvalued. I know of a junior economist within rather less than three miles from Ludgate Circus who succeeded in elaborating a set of figures showing that the increase of British invisible exports during 1936 exactly balanced the increase of the adverse visible trade balance. On second thoughts he arrived at the conclusion that some evil-minded cynics might question the authenticity of this strange coincidence, and when the figures were published they showed a convenient and convincing difference of some £5 millions. And there are still naïve souls in this world who are duly impressed whenever arguments are supported by figures.

Doubtless there was some increase in invisible exports, but it failed to cover anything like the whole of the increase of the visible adverse trade balance, whose existence is conclusive evidence of the overvaluation of sterling The imagination of stabilisationists is, needless to say, by no means exhausted by producing the argument of the increased invisible exports. They hold another argument in reserve, namely, that the reason why exports did not keep pace with the increase of imports was that British industries were too busy executing rearmament orders to bother about exports. The one or two instances in which British firms declined foreign orders for aeroplanes or other similar goods are given wide publicity so as to convey the impression that it is the rule and not the exception. As a matter of fact, apart from the firms working to the full limit of their capacity for the requirements of national defence, British industries in general are as keen as ever on maintaining and increasing their foreign sales. If they are not in a position to quote lower prices, this is not their fault but the fault of the overvaluation of sterling.

(7) Forward Dollars indicate Overvaluation of Sterling

In addition to the evidence of a persistent and growing trade deficit the overvaluation of sterling is also indicated by the persistent premium on the forward dollar. For a short while such a premium may be due to temporary speculative factors. When, however, it remains in existence for nearly two years, and stands most of the time at figures not justifiable by the difference in interest rates, then it is reasonably safe to regard the phenomenon as indicating the overvaluation of sterling. At any rate, the persistent premium on the forward dollar does indicate that the Foreign Exchange market, the business community and investors concerned with hedging against the exchange depreciation on their investment hold the view that sterling is overvalued. They may be wrong, but the chances are against the majority of market opinion being wrong for nearly two years. It is worth while noting that the premium remained in existence independently of the fairly wide fluctuations of the spot sterling–dollar rate. Forward dollars remained at a premium whether spot dollars were weak or firm.

The effect of the overvaluation of sterling may, of course, be neutralised, and more than neutralised, for a long time by the repatriation of British funds from Wall Street or by a fresh flight of capital from France. The firmness of an exchange through capital movements is not, however, a proof against its overvaluation, any more than its weakness through capital movements in itself proves its overvaluation. The only reliable indices we possess are the trade balance and the forward exchange rate. As we have seen, both these indices confirm the overvaluation of sterling.

CHAPTER LI

THE BRITISH POLICY

(1) Expansion and Rearmament

We have seen in the last chapter that there is good reason to suppose that sterling is overvalued in relation to the dollar. The question is whether its overvaluation is likely to increase or disappear in the future. To a large extent this depends upon the policy pursued by the British and United States Governments.

Is there any likelihood that the expansionary policy adopted by Mr. Chamberlain will be reversed during 1937? The odds are overwhelmingly against it. The policy of expansion was originally adopted for the sake of reducing unemployment to normal proportions. This consideration still exists, for while in certain branches of trade all the unemployed have been absorbed, there remain at the time of writing still between 1,500,000 and 1,600,000 unemployed. In the meantime the policy of expansion has been reinforced by the necessity of rearmament. While it may be a matter of opinion whether or not Mr. Chamberlain will check or even reverse expansion once the number of unemployed has declined to the million mark, there can be no two opinions as to whether he is now likely to continue the policy which through its effect is bound to lead to expansion independently of the decline in the number of unemployed. Rearmament is likely to continue on an increasing scale during the coming years, and is bound to lead to a marked rise in British commodity prices. In particular, in those branches of industry which are directly or indirectly concerned with rearmament, unemployment has already been, or is shortly likely to be, reabsorbed, and the scarcity value of workmen will lead to wages demands which will have to be met. We shall witness an all-round rise in wages and a corresponding all-round rise in manufacture prices.

This movement will not confine itself to rearmament industries. Already there is a strong rising tendency in the cost of living, and this is likely to become accentuated, partly

through an increased demand for raw materials and partly through the increase of purchasing power which will continue to absorb the surplus stocks of foodstuffs. The rise in the cost of living will intensify the pressure for higher wages and will spread the rising tendency of prices over practically every direction until it assumes the character of a universal upward movement of the price level.

(2) Orthodox Economists raise False Alarm

Orthodox economists view the situation and the prospects with growing concern. They would like to see the Government adopt a deliberate policy of deflation so as to check the upward movement of prices. We hear once more the old war cry about being in the middle of a dangerous speculative boom which should be checked by higher bank rate and credit restrictions. Orthodox economists have been crying "wolf" so often since Great Britain began to emerge from the depression that they can hardly expect to carry much conviction this time, and in all probability the Government will ignore their advice. Indeed, it is difficult to justify their contention that the conditions prevailing in British trade are boomlike. There is, of course, feverish activity in rearmament trades, but that is independent of monetary considerations. There is also a housing boom, but when we have said this we have said everything. The coal and textile industries continue to be depressed, and the majority of other industries not concerned with rearmament are just beginning to be more or less prosperous after a series of lean years. Even the housing boom is not nearly so dangerous as orthodox economists claim it to be. In any case, in order to stop the housing boom it is hardly reasonable to expect the Government to take measures which, if effective, would increase depression in the coal and textile trades and would go a long way towards checking the moderate prosperity in the majority of other trades.

While the false alarm raised by orthodox economists has failed to impress official quarters, it has unquestionably produced mischievous results in the form of a fall in Government stocks early in 1937. The result will be an unnecessary increase in the cost of financing rearmament.

(3) The Gold Position

The agitation in favour of deflationary measures is likely to become intensified if there should develop a strong adverse pressure on sterling. Everybody realises that the Govern-

ment will not repeat the experience of 1931 by spending every ounce of gold it possesses for the support of sterling. Indeed, one of the main reasons why Mr. Chamberlain is not prepared to agree to legal stabilisation is to avoid having to defend sterling at such cost. Where views are divided is regarding the extent to which the authorities are prepared to spend their gold reserve in defending sterling at the present level for the sake of maintaining the Tripartite Agreement. Nobody knows the amount of gold held by the Exchange Equalisation Account, but it is easy to imagine a situation in which that reserve would become exhausted through adverse trade balance and the withdrawal of foreign capital. Having reached that stage, will the Government retransfer some of the gold transferred in recent years from the Exchange Equalisation Account to the Bank of England? Or will it prefer to allow sterling to depreciate at the risk of breaking up the Tripartite Agreement? Until recently it appeared as though there was no alternative but to allow sterling to depreciate or to withdraw gold from the Bank of England even at the cost of bringing about credit restrictions in consequence.

In December 1936, however, a transaction was carried out between the Bank of England and the Exchange Equalisation Account which opened the possibility of a third course. The Exchange Equalisation Account transferred £65 millions of gold to the Bank of England, and simultaneously the fiduciary issue—that is, that part of the note issue which is not covered by the metallic reserve—was reduced by £60 millions. In announcing this measure, Mr. Chamberlain emphasised that it was of a temporary character. This means that should the flow of gold become reversed and the Exchange Equalisation Account run short of gold, the Bank of England would doubtless recede the £60 millions and its fiduciary issue would be raised once more by a similar amount. It is possible that the Government would not limit the transfer of gold from the bank to the Exchange Equalisation Account to the figure of £60 millions. Until recently it was believed that any transfer of gold would inevitably lower the basis of credit. It has now become conceivable, however, to withdraw gold in addition to the £60 millions temporarily transferred and to prevent the transfer from affecting the basis of credit by a corresponding increase of the fiduciary issue.

(4) Choice between Tripartite Agreement and Cheap Money

Technically it has thus become possible to draw extensively upon the Bank of England's own gold reserve without thereby reversing the Government's cheap money policy. In practice, however, this course could not be taken indefinitely without producing the adverse effects it aims to avoid. The psychological effect of the retransfer of gold from the Bank of England would be a rising tendency of interest rates, even if the basis of credit were left unaffected. Thus the very transaction, which would be undertaken for the purpose of supporting sterling, would in fact accentuate the adverse pressure on sterling. We have seen in the last chapter that the transfer of gold to the bank provoked a wave of optimism towards sterling because it was interpreted as a sign of strength. It stands to reason that a reversal of the transaction would be interpreted as a sign of weakness. Should the amounts retransferred from the Bank attain considerable proportions, it would give rise to a wave of pessimism that would make the task of the Exchange Equalisation Account rather difficult, in spite of the addition to its resources available for defending sterling.

Thus even if we assume that the Government is prepared to use the Bank's gold stock for supporting sterling, we must realise that this course cannot be pursued indefinitely. A stage is bound to be reached sooner or later at which Mr. Chamberlain will have to make up his mind whether to sacrifice his cheap money policy or the Tripartite Agreement. It seems probable that, confronted with such a dilemma, he will decide in favour of maintaining his cheap money policy, even at the cost of allowing sterling to depreciate.

(5) The Long View

As things are at the time of writing, it seems possible that this dilemma will not arise for a long time to come. Taking a long view, however, the overvaluation of sterling will inevitably lead to the depletion of the gold reserve of the Exchange Equalisation Account. The latter has to supply the gold to fill the gap, and since the counterpart of the gold ceded in order to cover the trade deficit remains in the form of foreign balances in London, the position of sterling will become increasingly vulnerable in the course of time unless the trend of trade changes in favour of sterling. We have seen above that

the prospects of such a change being brought about by the reversal of the existing expansionary tendency in Great Britain are anything but favourable.

There is, however, another way by which the overvaluation of sterling might decline or even disappear, and that is through an expansion abroad on a scale in excess of the British expansion. The countries which are chiefly concerned are the two great rivals of British exports, Germany and the United States. So far as Germany is concerned, internal expansion is undoubtedly in excess of the expansion experienced in Great Britain. The significance of this fact is, however, reduced by the essentially artificial character of German export trade, which no longer depends on relative price levels. There is indeed little hope of reducing the abnormal trade deficit unless expansion in the United States leads to a rise in manufacture prices in excess of those of rival British manufactures. Whether or not we have the right to expect such developments will be examined in the next chapter.

CHAPTER LII

THE AMERICAN POLICY

(1) President Roosevelt drifting towards Orthodoxy

As we have seen in the last chapter, there is every likelihood of continued economic and monetary expansion in Great Britain. Whether or not this expansion will increase the existing overvaluation of sterling in relation to the dollar depends, of course, upon the degree of prospective expansion that is likely to take place simultaneously in the United States. Until a year or so ago there appeared to be every reason to assume that expansion would be greater in the United States than in Great Britain. After all, ever since his advent to office President Roosevelt has declared himself in favour of a deliberate policy of expansion, and has inaugurated various policies to that end. At the same time the British policy of expansion has until recently been very moderate and cautious. It is only since the adoption of the rearmament programme that expansion in Great Britain has become accentuated, not as a matter of policy but out of sheer necessity of national defence. Even now the figure of British rearmament expenditure is but a fraction of the huge American public works schemes.

Notwithstanding this, it now appears that expansion in the United States will not keep pace with expansion in Great Britain. In the course of 1936 President Roosevelt's attitude underwent a remarkable change. Even in 1935 he had promised the American business community to suspend his reforming zeal, and to give a " holiday " from fresh legislation. Ever since he has been drifting towards monetary orthodoxy. While until 1935 it had been his declared policy to bring about a rise in commodity prices by deliberate reflationary measures, during 1936 he went out of his way to counteract even such natural reflationary tendencies as were brought about by the influx of gold. The Federal Reserve Board's decision to raise the reserve requirements of member banks, and the Government's decision to sterilise the new gold influx, duly indicate the change in the official American monetary policy.

While it would hardly be justifiable to call it deflationary, it can safely be regarded as anti-inflationary, and even as anti-reflationary.

(2) Causes of Change of Policy

This change of monetary policy may be explained to a large degree by the recovery of produce prices that has taken place since the advent of President Roosevelt. There can be no doubt that the rise has already brought considerable relief to the American farmer and to American debtor classes in general. While even now they are a long way from the state of prosperity they enjoyed in 1929, the desperate conditions of 1932 and 1933 are definitely a matter of the past. The burden of private indebtedness has in any case become considerably mitigated since 1933, not only through the rise in commodity prices and the improvement in business but also through the Government's relief to debtors and through defaults and compositions. The weakest debtor positions have been eliminated by such means, and most of those who were strong enough to survive have now become more or less solvent. There is no longer the same pressure on the part of the debtor classes for higher commodity prices in order to relieve the real burden of their debt. In any case, as a result of rearmament in Europe, commodity prices are now rising without any artificial stimulus.

Another important reason why President Roosevelt has changed his policy lies in the fear that further reflation might lead to a reckless speculative boom in Wall Street. It is in order to prevent such a boom that the anti-reflationary measures were initiated. After all, trade is still far from being satisfactory in the United States, and the number of unemployed is still well over 10 million. This being so, it would be distinctly premature to be afraid that further credit expansion might lead to a trade boom. On the other hand, there is ground for fear that Wall Street might develop a speculative fever similar to that of 1928 and 1929. It is in order not to stimulate such a movement by means of ample credit resources that the United States authorities resorted to measures aiming at reducing the volume of idle cash.

Even though the anti-reflationary measures are not directed against the rise in commodity prices, their effect is hardly likely to remain confined to Wall Street. Should these measures, together with speculation in Wall Street, lead to higher interest rates, this is bound to act as a check on the

rising tendency of commodity prices. In all probability the rise would continue, owing to the demand for rearmament. The United States has, however, definitely relinquished the initiative in provoking the upward movement of commodity prices—initiative which she held incontestably between 1933 and 1935. The rise in American commodity prices will probably be merely the reflection of the rise in the world level.

(3) The Labour Factor

As for the price of manufactures in the United States, some quarters are inclined to believe that, owing to the prospects of a better organisation of labour and consequently of more emphatic wages demands, there is a likelihood of a rise in the cost of production. It ought to be borne in mind, however, that during times of prosperity it is by no means easy to induce American workmen to organise themselves on the pattern of British Trade Unionism. In any case, with the huge reserve of unemployed, it is difficult to imagine that wages demands in the United States would be so successful as those in Great Britain. Lack of organisation, wholesale blacklegging through the willingness of the unemployed to step into the place of strikers, and the brutal but efficient system of strike-breaking existing in the United States, will no doubt keep down the rise in wages, which will lag considerably behind the rise in British wages. It is true that should President Roosevelt succeed in overthrowing the Supreme Court and in reinstating his New Deal legislation, this would accentuate the rise in wages, but even allowing for this possibility, it appears probable that in Great Britain the rise in wages will be faster.

There remains, of course, the effect on prices of the large budgetary deficit due to a large degree to public works schemes. In reality there is reason to believe that the deficit will be radically reduced in the near future. Moreover, in consequence of the rise in trade activity, many of the public works schemes will probably be shelved, and those which are maintained will probably be executed in a leisurely fashion, which would minimise their effect on commodity prices. At the same time, in Great Britain rearmament will have to continue on an increasing scale, irrespective of its effect on commodity prices.

(4) British Prices likely to rise Faster than American Prices

Given these facts, it is difficult to escape the conclusion that the rise in commodity prices will be more pronounced in Great Britain than in the United States. Even during 1936 American prices failed to keep pace with British prices. During the past year, American wholesale prices advanced by 4 per cent, while at the same time British wholesale prices increased by more than 8 per cent. The chances are that the discrepancy will become accentuated during 1937. At the time of writing the overvaluation of sterling is more pronounced than it was twelve months ago, and the chances are that in twelve months' time it will be even more evident.

This being so, it is difficult to understand the stubborn determination with which the Washington Administration aims at preventing the downward adjustment of the sterling–dollar rate. Surely the experience of 1931 conclusively proved that the overvaluation and vulnerability of sterling is apt to lead to a crisis with world-wide repercussions. Let us assume, for the sake of argument, that in connection with a general agreement covering currency, war debts, trade relations, etc., Mr. Chamberlain were to agree to stabilise the sterling–dollar rate at the present level. Within a year or two the drain on sterling due to its overvaluation would become unbearable. Any attempt on the part of the United States authorities to bring relief to sterling by reflating might lead to a speculative boom in Wall Street, which would accentuate the drain on London rather than mitigate it. In order to avoid having to suspend the gold standard once more, the British Government would have to embark upon a policy of deflation. It would be political suicide for any Government to take that course. The contrast between recovery and prosperity while sterling was free, and deflationary depression under a régime of stability, would be too marked to be overlooked by most of the electorate. Sooner or later the Government would be forced by public opinion to take the line of least resistance and suspend the gold standard once more. Sterling would then again become grossly undervalued compared with the dollar, just as it was between 1931 and 1933, and the deflationary effect produced by its undervaluation abroad would lead to the recurrence of the American crisis experienced in 1932–3.

(5) Need for allowing Sterling to Depreciate

The alternative course is for the United States Government to agree to a depreciation of sterling to an extent necessary for its adjustment to its purchasing power parity with the dollar. Indeed, since the exact figure of that equilibrium level cannot be ascertained with a too high degree of accuracy, it would be advisable to err on the side of safety and allow sterling to become, if anything, slightly undervalued. In possession of a huge surplus of gold stock, the United States could well afford to stand the moderate pressure thus caused without having to resort to deflationary measures to counteract it. In the course of time the excess of British expansion over American expansion would in any case restore equilibrium.

There seems to be very little chance that the United States authorities would agree to such a policy. In all probability they will continue to insist upon preventing a decline of the sterling–dollar rate below 4.86, even after the extent of the overvaluation of sterling has become considerably accentuated. It is utterly unlikely, however, that the British Government would lend itself to being bled white in the defence of an overvalued sterling. Sooner or later the sterling–dollar rate will have to be adjusted to its natural level, with or without the agreement of the United States Administration.

CHAPTER LIII

CONCLUSION

(1) Defence of Currency at All Costs

Post-war financial history, viewed from the angle of the general attitude towards monetary policy, can be divided into three periods. During the first period, considerations of monetary policy were regarded as all-important, and it was taken for granted that everything should be subordinated to them. The desire that sterling should be able to look the dollar in the face determined not only the monetary policy of Great Britain but also her budgetary and trade policy. Sterling had to be restored to its pre-war parity irrespective of the consequences, and it had to be maintained at the old parity regardless of the sacrifices involved. In Great Britain this conception prevailed until September 1931. In the United States it continued to prevail until 1933. In France the "monetary policy *über alles*" conception did not begin to manifest itself until after the stabilisation of the franc in 1928. Having appeared late, it continued to prevail long after it had been discarded in both Great Britain and the United States—to be exact, until September 1936. In Italy, the Pesaro statement in August 1926 marked the beginning of the supremacy of monetary policy over everything else. It was discarded at the beginning of 1935. Germany adopted the same conception after the stabilisation of the mark in 1924, and continued to adhere to it until 1933, when after the advent of the National Socialist régime the policy of creating employment and of rearming at all costs was adopted.

(2) Trade Revival at All Costs

During the second phase, monetary policy was subordinated to the requirements of trade. The conception was adopted during the acute crisis and the prolonged depression that a recovery of trade had to be achieved at all costs, and considerations of monetary policy were subordinated to this goal. In Great Britain this phase was entered in 1932. The suspension of the gold standard in 1931 did not altogether bring

the supremacy of monetary policy to an end. While the defence of sterling at its old parity was abandoned, desperate efforts were made in the form of high bank rate, drastic all-round economies and heavy taxation to minimise the depreciation of sterling. It was only after the tide had turned and sterling became firm that the adoption of the cheap money policy heralded the beginning of the second phase. In the United States the advent of President Roosevelt marked the beginning of the second phase. In no other country has monetary policy been subordinated so completely to the desire to enforce a trade revival at all costs. In France the second phase began with the devaluation of the franc, though even now considerations of monetary policy play a relatively important part in the French mind. The new level of the franc, elastic as it is, is now considered almost as sacrosanct as the parity of 1928. Italy entered the second phase early in 1935, when efforts at further deflation for the sake of defending the lira were abandoned. With the advent of the National Socialist régime, Germany also entered the second phase. Even though she continued to maintain the reichsmark at the old parity, she embarked upon a policy of public works very much against the requirements of monetary policy.

(3) Rearmament at All Costs

The third phase was characterised by the supremacy of rearmament requirements over considerations of monetary policy and, in so far as they came into conflict, over the requirements of normal trade. In Great Britain it is difficult to ascertain the date when the expansion embarked upon reluctantly by the Government ceased to be dictated primarily by the desire to reduce unemployment and began to be dictated by the necessity of rearmament. It is reasonable to assume that the change took place after the General Election of 1935, presumably early in 1936. In the United States, the necessity for rearmament has not so far arisen, and monetary policy continues to be guided by considerations of trade. The supremacy of trade requirements over those of monetary policy has declined, however, with the progress of trade revival and with the drifting of President Roosevelt toward monetary orthodoxy. In France the second phase was merged with the third phase, since considerations of national defence played at least as important a part in inducing M. Blum to devalue the franc as a desire to terminate the depression.

In Italy, preparations for the Abyssinian campaign and defence against sanctions overshadowed considerations of trade during 1935. Monetary policy, which reigned supreme until the beginning of that year, came to be regarded as a subordinate means in the service of the nation's military efficiency. Germany was the first to enter the third phase, though it is difficult to form an opinion when reflation became due primarily to rearmament. Presumably the change took place some time during 1934, though possibly even in 1933.

The five countries mentioned above were not alone in experiencing these three phases. Many other countries went through them with greater or less modification. In Soviet Russia, monetary policy has never played the same predominant part as in capitalist countries. Until 1934 the success of the Five Year Plan was the primary consideration in the mind of the Soviet authorities. But from the time of the tension in the Far East, rearmament overshadowed everything else, even in Soviet Russia. In Belgium, monetary policy ceased to reign supreme in March 1935 when the belga was devalued. Considerations of national defence began to overshadow those of trade recovery, presumably from the time of the Rhineland re-occupation. In Holland and Switzerland, monetary policy remained the most important consideration until the devaluation of September 1936. In Japan the second phase was missed out altogether, and the depression due to the defence of the yen at an overvalued level gave way in 1931 to a policy guided solely by considerations of national armament.

(4) Reflation and Disequilibrium

At the time of writing, practically all countries in Europe and several countries outside Europe are under the régime of rearmament. They pursue an expansionary monetary policy, but the object is no longer to create employment and cause a trade revival by reflationary means. This is no longer considered necessary, since in most countries employment and trade have already improved to a considerable degree. The supreme consideration is the strengthening of the nations' armed strength to the utmost limit of their financial, monetary, economic and technical capacity. In doing so, the authorities in all these countries are reflating, but this is no longer done deliberately. Expansion is now considered the necessary evil that inevitably accompanies military preparations.

How is this trend likely to affect the existing conditions

of disequilibrium, international and internal? All depends upon the relative pace at which rearmament is pursued during the coming years. Whether or not various currencies are undervalued or overvalued a few years hence will depend upon the extent to which they consider it necessary to expand for armament purposes. Although other considerations will remain in force, this will overshadow all of them.

(5) Effect on Internal Disequilibrium

The internal disequilibrium between fictitious wealth and real wealth will undergo a substantial change in every country engaged in the armament race. On the one hand, the cost of armament, in so far as it is met by borrowing, will swell the burden of deadweight indebtedness. On the other hand, the rise in commodity prices will reduce the real weight of that burden. The question is whether in any particular country the proportion of the internal depreciation of the monetary unit is greater or less than that of the increase of fictitious wealth through armament expenditure. This depends to a large degree upon the monetary policy of the Governments. If they aim at keeping down the depreciation of the monetary unit, the result will be an increase of the burden of fictitious wealth until it becomes unbearable and until it compels the Governments to change their monetary policy. If, on the other hand, a rise in commodity prices, wages, etc., is not checked, the real burden of fictitious wealth might possibly decline in spite of the increase of its nominal amount through additional borrowing.

One thing is certain. Before the rearmament race began there was hope that an expansionary policy would lead to the reduction of the burden of fictitious wealth, not only through the depreciation of the monetary unit but also, and possibly primarily, through the increase in the production of real wealth. The same amount of deadweight debt becomes more bearable, even though the commodity value of the monetary unit remains unchanged, if the volume of real wealth which constitutes its foundation is increased. An expansionary monetary policy was calculated to reduce the relative weight of indebtedness both in the destructive way, by lowering the purchasing power of the monetary unit, and in the constructive way, by leading to an increase of capital goods and consumption goods. Since the beginning of the rearmament race, however, monetary expansion is capable only of reducing the burden of fictitious wealth or preventing its increase in a

destructive way by lowering the purchasing power of the monetary unit. The productive energies created through the monetary expansion have been placed entirely at the service of rearmament. The additional goods produced by expansion are not goods in the economic sense of the term. They do not increase the national wealth or the standard of living. They cannot be regarded as a counterpart of the increase of the deadweight indebtedness. They may be useful and necessary from the point of view of national defence, but from an economic point of view they constitute utter waste, just as almost the whole of the war expenditure between 1914 and 1918 constituted complete waste.

This means that in order to restore equilibrium between fictitious wealth and real wealth, a much higher degree of currency depreciation will be necessary than would have been necessary in the absence of a rearmament race, which, apart from adding to the nominal amount of the fictitious wealth, also prevented its reduction by the constructive means of raising the value of real wealth. Even before rearmament, a drastic devaluation of all currencies with excessive fictitious wealth was a necessity. As things are, devaluation will eventually have to be even more drastic. Whether or not the Governments realise this makes no difference in the long run. Drastic devaluation will have to come, sooner or later. Whenever the desire to prevent further devaluation comes obviously into conflict with the requirements of rearmament, the latter consideration will prevail sooner or later.

(6) Effect on International Disequilibrium

How will the armament race affect the international disequilibrium between the various countries? While expansionism was prompted by the desire to revive trade, there was a chance that the degree of expansion might be influenced by international considerations; that a Government, if it had no desire to allow its currency to depreciate, would limit its monetary expansion so as to avoid an excessive overvaluation of the exchange. As, however, the pace of expansion is now dictated by supreme considerations of national defence, the Governments are no longer in a position to conduct their monetary policy with an eye to considerations of international equilibrium. No matter how strongly a currency may be overvalued, the policy of expansion will continue, irrespective of consequences, if this is considered necessary for the national defence.

In such conditions, a disequilibrium of 10–20 per cent or more might easily develop between the currencies of two countries, within a relatively brief space of time, owing to the difference between their respective degrees of expansion. This being so, it is the height of absurdity to try to stabilise the exchanges in relation to each other at their present level. Owing to the rearmament race, all currency values are in the melting-pot. Any attempt at establishing rigid ratios between them is doomed to failure the moment when it is realised that the artificial stability has come into conflict with the requirements of national defence.

INDEX

Abyssinia, 4, 5, 8, 13, 58–9, 97, 119, 124, 129–31, 132 *et seq.*, 139 *et seq.*, 219–20
Akzept-Bank, 115
Auriol, Vincent, 14, 82, 178 *et seq.*, 185 *et seq.*, 232, 271–2
Austria, 55–6, 59, 131, 134, 155, 249, 302

Badoglio, Marshal, 139–40
Baldwin, Stanley, 106
Bank for International Settlements, 200, 204
Banking difficulties:
— in Belgium, 12, 27, 30, 72
— in Switzerland, 12, 41, 46, 71–4
— in the United States, 12, 27, 72
Bank of Danzig, 77–8
Bank of England, 107–8, 110, 149, 151, 192, 200, 240, 277–8, 316, 323–4
Bank of France, 11, 47 *et seq.*, 62, 65, 80 *et seq.*, 86, 90, 148 *et seq.*, 160, 162, 167, 169–70, 173 *et seq.*, 183–4, 185 *et seq.*, 193, 234–5, 269 *et seq.*, 295, 297
Bank of Italy, 120, 136
Bank of Poland, 250–1
Banque Commerciale de Bâle, 72
Banque de Paris et des Pays Bas, 53
Baumgartner, M., 88
Beaverbrook, Lord, 203
Belga, 10, 23, 28 *et seq.*, 34, 39, 40, 216, 235, 333
Belgium, 10, 12, 20, 23, 27 *et seq.*, 34–6, 52, 77, 84, 89, 91, 120, 169, 233, 235, 237, 241, 301, 309, 333
Beneš, Dr., 138
Benn, Sir Ernest, 201
Blum, Léon, 14, 64, 82, 161, 163–5, 167 *et seq.*, 176–7, 178 *et seq.*, 185 *et seq.*, 191 *et seq.*, 209, 221, 222, 224, 226, 231–3, 236, 246, 271, 273, 297, 299
Bonnet, Georges, 183–4, 208
Bouisson, Fernand, 11, 52–3
Brüning, Dr., 4, 11, 57, 59, 113
Bulgaria, 284

Caballero, Largo, 164
Caillaux, Joseph, 52–3
Caisse Autonome d'Amortissement, 170
Caisse de Dépôts et de Consignations, 49, 148–9, 295
Cannan, Professor, 201
Carnegie Endowment, 204
Chamberlain, Neville, 12, 88, 106 *et seq.*, 174, 203, 208–9, 215, 218 *et seq.*, 224, 263, 292, 321, 323–4, 329
Chile, 100, 303
China, 312
Colijn, Dr., 11–12, 36–7, 66 *et seq.*, 80, 260
Coughlin, Father, 203
Creditanstalt, 55
Czechoslovakia, 134, 137–8, 248 *et seq.*, 252

Daladier, E., 64
Danzig, Free City of, 75 *et seq.*
Deflation:
— abandoned in Italy, 13, 119, 123–4
— after 1929, 10
— by Dr. Colijn, 11–12, 67–8
— by M. Laval, 11–12, 62 *et seq.*, 80–3
" Consistent "—, 11, 23, 62–4, 67–8, 121–2, 123
— in Belgium, 28

Deflation (*continued*)
— in France, 48 *et seq.*, 62, 150, 205–7, 209–10
— in Gold Bloc countries, 22–3
— in Great Britain, 107
— in Switzerland, 40
Limitations of —, 23
M. Germain Martin and —, 174
M. Jenny and —, 175
M. Mitzakis and —, 175
M. Rist and —, 172–4
Political consequences of —, 3 *et seq.*, 64–5, 80 *et seq.*, 88, 91, 113, 129, 154 *et seq.*, 159 *et seq.*
— prevents adjustment of disequilibrium, 19
— reversed in Gold Bloc, 95 *et seq.*
Delaisi, M., 160
Denmark, 79
de Rothschild, E., 50, 90, 261
Devaluation:
— and Belgium, 30, 31–2, 77, 89, 233, 235, 237
— and Danzig, 75 *et seq.*
— and France, 14, 83–5, 87 *et seq.*, 147, 150, 152, 157–8, 159 *et seq.*, 168, 171, 172 *et seq.*, 178 *et seq.*, 185, 190, 191 *et seq.*, 205 *et seq.*, 221, 223–4, 231 *et seq.*, 237 *et seq.*, 273
— and Gold Bloc currencies, 7
— and Holland, 36–7, 237 *et seq.*, 257 *et seq.*
— and Italy, 14, 121 *et seq.*, 129–30, 243 *et seq.*
— and rearmament, 283
— and Switzerland, 43, 73, 237 *et seq.*, 257 *et seq.*
— and the United States, 89
— and Tripartite Agreement, 223–4, 227
Germany and —, 244, 248–9, 252 *et seq.*
M. Germain Martin and —, 174–5
M. Jenny and —, 175
M. Mitzakis and —, 175
M. Rist and —, 174
— necessitated by fundamental disequilibrium, 7
de Wendel, M., 50, 90, 179, 261
Djibouti–Addis Ababa Railway, 58
Dollar, 8, 15–16, 29, 76, 101, 103, 149, 194, 205, 208, 211 *et seq.*, 218–19, 224 *et seq.*, 237, 248, 274 *et seq.*, 310–12, 315–16, 320, 329–30, 331
Dollfuss, Dr., 155
Doumergue, President, 48–9, 61, 174

Eden, Anthony, 142
Einzig, Paul
Behind the Scenes of International Finance, 3, 55
Finance and Politics, 55
France's Crisis, 6, 156
Monetary Reform in Theory and Practice, 3
Montagu Norman—A Study in Financial Statesmanship, 55
World Finance Since 1914, 3, 4, 6, 7, 10
Exchange Equalisation Account, 29, 107, 110, 199–200, 224–5, 264–5, 269, 275 *et seq.*, 316, 323–4

Feder, Gottfried, 254
Federal Reserve Bank of New York, 258
Finaly, Horace, 53
Financial News, The, 128, 151
Flandin, P. E., 11, 49 *et seq.*, 55, 82, 90, 174, 186, 297
Franc (French), 6, 7, 8, 10, 35, 37, 39, 40, 46, 47 *et seq.*, 61 *et seq.*, 66, 72, 80 *et seq.*, 86 *et seq.*, 127, 147 *et seq.*, 156–8, 159 *et seq.*, 167 *et seq.*, 172 *et seq.*, 178 *et seq.*, 185 *et seq.*, 191, 205 *et seq.*, 218–19, 224 *et seq.*, 231 *et seq.*, 237 *et seq.*, 243, 246, 248 *et seq.*, 257, 264, 267, 268 *et seq.*, 274 *et seq.*, 296 *et seq.*, 310–12, 315, 331–2
Franc (Swiss), 10, 12, 34, 37, 39, 40 *et seq.*, 47, 66, 70 *et seq.*, 237 *et seq.*, 243, 257 *et seq.*
France, 5, 6, 7, 11 *et seq.*, 13, 15, 20 *et seq.*, 34, 46, 47 *et seq.*, 55 *et seq.*, 61 *et seq.*, 66–7, 72, 80 *et seq.*, 86 *et seq.*, 95 *et seq.*, 117–18, 120, 131, 147 *et seq.*, 154 *et seq.*, 159 *et*

France (*continued*)
seq., 166 *et seq.*, 172 *et seq.*, 178 *et seq.*, 185 *et seq.*, 191 *et seq.*, 204, 205 *et seq.*, 214, 216 *et seq.*, 222 *et seq.*, 231 *et seq.*, 237 *et seq.*, 243 *et seq.*, 252 *et seq.*, 257 *et seq.*, 263 *et seq.*, 268 *et seq.*, 274, 278, 286, 295 *et seq.*, 301, 320, 331–2
Franco, General, 164–5
Frankfurter Zeitung, 157–8

Gamelin, General, 155
Garibaldi, Enzio, 58
Germany, 4, 12–13, 14, 15, 19, 23, 38, 41, 55 *et seq.*, 71–3, 75–6, 88, 95, 97, 101, 112 *et seq.*, 131, 132, 134, 135, 140–1, 154 *et seq.*, 164–5, 187, 189–90, 220–1, 227, 242, 243–4, 247, 248 *et seq.*, 252 *et seq.*, 281 *et seq.*, 288, 293, 295, 301–2, 313, 325, 331–3
Goebbels, Dr., 158
Goering, General, 116–17
Gold :
Earmarking of —, 14, 224–5, 264–6
Efflux from Belgium, 29
Efflux from Danzig, 76
Efflux from France, 52, 83–4, 86–7, 148–9, 161–2, 169, 188, 193, 270
Efflux from Holland, 38, 68
Efflux from Italy, 136–7, 139–40
Efflux from Switzerland, 45–6
Maldistribution of —, 20–1
Private arbitrage in —, 266–7
Gold Bloc :
— and attack on franc, 47
— and attack on guilder, 34 *et seq.*
— and Belgian devaluation, 32, 42, 216
— and Danzig devaluation, 77, 79
Anticipated devaluation of —, 44–5
Collapse of —, 13, 23, 237 *et seq.*
Disequilibrium in —, 22, 27
Effect of devaluation in —, 15
Failure of deflation in —, 10
Italy abandons —, 124
Gold Bloc (*continued*)
M. Rist and —, 173
Reflation in —, 98
Rise of commodity prices in —, 95
Rise of production in —, 98
Satellites of —, 75, 95
Tripartite Agreement compared with —, 225
Gold Discount Bank, 115
Great Britain, 4, 10, 13, 15, 17 *et seq.*, 28, 29, 36, 40, 45, 47, 56–9, 79, 82, 84, 88, 89, 100, 102, 106 *et seq.*, 121, 124, 133–4, 137–8, 143–4, 149–51, 164–5, 166, 168–9, 173–4, 187, 192, 194, 199 *et seq.*, 205 *et seq.*, 211 *et seq.*, 216 *et seq.*, 222 *et seq.*, 237–8, 240–1, 254–6, 263–6, 275 *et seq.*, 283, 285–6, 288 *et seq.*, 295, 298, 309 *et seq.*, 315 *et seq.*, 321 *et seq.*, 326 *et seq.*, 331–2
Greece, 248, 253
Gregory, Professor T. E., 201
Guilder, 10, 34 *et seq.*, 46, 47, 66 *et seq.*, 237 *et seq.*, 257 *et seq.*
Gulden (Danzig), 75 *et seq.*

Hawtrey, R. G., 108, 111, 134, 314
Hayek, Professor, 201
Hitler, 4, 5–6, 11, 13, 57–9, 114, 116, 131, 138, 140–1, 154–6, 164–5, 249
Hoare, Sir Samuel, 58–9
Herriot, E., 207
Holland, 10 *et seq.*, 34 *et seq.*, 44, 66 *et seq.*, 80, 95, 120, 169, 216, 237 *et seq.*, 243, 252, 257 *et seq.*, 301, 309, 333
Hoover, President, 56, 57
Hopkins, Sir Richard, 111
Hungary, 131, 134, 249, 284, 302

India, 312
Inflation :
— and American public, 103
— and rearmament, 15
— and sanctions, 141
— during and after the war, 18
— in France resumed, 272
— in history, 17–18

Inflation (*continued*)
Post-war —, 10
— through issue of "greenbacks", 103
International Chamber of Commerce, 204
Italy, 4, 5, 13, 20, 23, 58–9, 97, 119 *et seq.*, 127 *et seq.*, 132 *et seq.*, 139 *et seq.*, 155, 164, 220–1, 237–8, 242, 243 *et seq.*, 249, 251, 252, 331–3

Japan, 4, 89, 100, 134, 302, 309, 312, 333
Jenny, Frédéric, 175
Jung, Guido, 123

Kellogg Pact, 139
Kemmerer, Professor E. W., 203
Koc, Adam, 250–1
Krone (Estonian), 75
Kruger, Paul, 36

Labeyrie, M., 183, 186
Lacour-Gayet, Georges, 90, 186–7, 261
Lausanne Conference, 57
Laval, Pierre, 5–6, 11–12, 14, 37, 54, 55 *et seq.*, 61 *et seq.*, 66–7, 80 *et seq.*, 86 *et seq.*, 118, 147, 154, 159 *et seq.*, 170, 174–5, 179, 182, 186–8, 207, 209, 259
League of Nations, 13, 59, 130, 132, 134, 192, 204
Leith-Ross, Sir Frederick, 111
Leopold, King of Belgium, 30
Leu & Co., Zurich, 72
Lira, 7, 13, 40, 119 *et seq.*, 127 *et seq.*, 141–2, 237, 243 *et seq.*, 248–9, 332
London School of Economics, 97, 108, 200–1, 203
Loucheur, Louis, 91
Louis, Baron, 3
Louis XV, 91
Luxembourg, 237

MacDonald, J. Ramsay, 106
Man, Henry de, 43
Mark (Finnish), 75
Martin, Germain, 174, 208
Mason, D. M., 201
Mises, Professor Ludwig von, 201
Mitzakis, Michel, 175
Monick, M., 150
Moret, C., 49–50
Morocco, 164–5
Morgenthau, Henry, 111, 199, 203, 212 *et seq.*, 224, 262, 275–6, 310, 315, 317
Münchhausen, Baron, 44
Mussolini, 4, 11, 13, 14, 58–9, 62–3, 119 *et seq.*, 127 *et seq.*, 133, 137–8, 139 *et seq.*, 155, 164, 243 *et seq.*, 249

Napoleon, 244
National Bank of Belgium, 29 *et seq.*
Netherlands Bank, 37–8, 68, 240, 260
New Deal, 101, 103, 112
Niemeyer, Sir Otto, 200
Norman, Montagu, 56, 107, 111, 200, 206

Phillips, Sir Frederick, 111
Pilsudski, Marshal, 251
Poincaré, R., 48, 53, 57
Poland, 75–6, 134, 164, 237, 248, 250–1

Rearmament, 8, 15, 254–6, 281 *et seq.*, 288 *et seq.*, 292, 295 *et seq.*, 299–300, 301 *et seq.*, 319, 321–2, 332 *et seq.*
Reflation:
— and rearmament, 15, 301 *et seq.*
— in Chile, 100
— in Germany, 12, 112 *et seq.*
— in Gold Bloc countries, 95 *et seq.*, 182
— in Great Britain, 12, 100, 106 *et seq.*
— in Greece, 100
— in Italy, 13
— in Japan, 100
— in Sterling Bloc, 100
— in the United States, 12, 22, 100 *et seq.*, 326 *et seq.*
Regnier, Henri, 168
Reichsbank, 113–15
Reichsmark, 13, 70, 97, 112, 117–18, 248, 252 *et seq.*, 332
Revel, Thaon de, 123

Reynaud, Paul, 82, 85, 88, 159, 161, 163, 174, 176, 178, 191, 207, 209
Rist, Professor Charles, 87, 172–4
Robbins, Professor Lionel, 173, 201
Robert, Maxime, 881
Roosevelt, President, 22, 100 *et seq.*, 106, 109–11, 112, 203–4, 208, 211 *et seq.*, 227, 235, 241, 276–7, 326–8, 332
Roumania, 164, 249–50, 302
Rueff, J., 88
Rydz-Smigly, Marshal, 251

Sanctions, 13, 132 *et seq.*, 139 *et seq.*
Sarraut, Maurice, 14, 147, 150–3, 155–7, 167–8, 170, 182, 188
Schacht, Dr., 12, 13, 112 *et seq.*, 138, 141, 244, 249, 252 *et seq.*, 283, 285–6
Snowden, Lord, 107
Sound Currency Association, 200–1
South Africa, Union of, 89
Soviet Russia, 194, 275, 333
Spain, 5, 95, 164–5, 194, 216
Speculation :
— against belga, 29, 30, 31
— against guilder, 34 *et seq.*, 66 *et seq.*
— against Swiss franc, 43 *et seq.*
— in Amsterdam, and Zurich, 44
Sprague, Professor, 203
Stabilisation :
— and Tripartite Agreement, 223 *et seq.*, 309–10
France and —, 14, 204, 205 *et seq.*, 214–15, 216, 219, 221, 311
Great Britain and —, 14, 107–8, 199 *et seq.*, 205 *et seq.*, 211 *et seq.*, 216 *et seq.*, 310 *et seq.*, 329 *et seq.*
Political aspects of —, 312–13
Post-war —, 10
Prospects of —, 15, 309 *et seq.*
U.S.A. and —, 14, 199, 203–4, 208–10, 211 *et seq.*, 216, 219, 221, 310, 329–30
State Bank of the U.S.S.R., 274–5
Stefani, Alberto di, 123
Sterling, 8, 15–16, 29, 76, 88, 107–8, 128, 149, 151, 169, 194, 199, 205–6, 208, 214–15, 216 *et seq.*, 224 *et seq.*, 237, 248, 263–6, 273, 274 *et seq.*, 292, 310 *et seq.*, 315 *et seq.*, 329–30, 331–2
Sterling Bloc :
— and Belgium, 31
— and France, 235
M. Germain Martin and —, 174–5
Reflation in —, 100
Tripartite Agreement compared with —, 225
Sweden, 79
Swiss National Bank, 42, 45–6, 70, 258
Switzerland, 10 *et seq.*, 12, 34, 37, 39, 40 *et seq.*, 70 *et seq.*, 95, 120, 134, 137, 169, 216, 237 *et seq.*, 243, 252, 257 *et seq.*, 301, 309, 333

Talleyrand, 244
Tannery, Jean, 49, 50, 81, 90, 150, 185–6, 261
Theunis, G., 29, 30, 91
Thorez, M., 178–80
Titulescu, N., 250
Toeplitz, G., 120
Townsend, Dr., 203
Tripartite Agreement :
Conclusion of —, 14, 195, 199, 204, 221, 222 *et seq.*
Extension of —, 248 *et seq.*
Terms of —, 222–3
Working of —, 224 *et seq.*, 262 *et seq.*, 274 *et seq.*, 309 *et seq.*, 316–17
Tripp, Dr., 240, 260
Turkey, 95, 133, 248, 284

United States, 4, 10, 12, 16, 18 *et seq.*, 27, 36, 56–7, 78, 84, 88, 89, 96, 100 *et seq.*, 106, 109–11, 112, 124, 133–4, 136, 142, 166, 169, 187, 194, 199, 203–4, 206 *et seq.*, 211 *et seq.*, 216, 221, 222 *et seq.*, 235, 241, 254–6, 264–6, 275 *et seq.*, 290, 302, 209 *et seq.*, 315, 317–18, 320, 321, 325, 326 *et seq.*, 331–2

van Zeeland, P., 31, 33, 235
Vissering, Dr., 261

Waley, S. D., 111
Wall Street:
  Boom in —, 21
Wall Street (*continued*)
  Slump in —, 21, 47, 104

Yugoslavia, 134, 137–8, 143, 164, 249–50, 253, 302

Zloty (Polish), 76–7, 250–1